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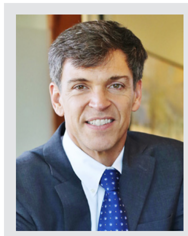
Investment Insights

Quarterly Investment Commentary | 4th Quarter 2019

Black Lab Puppy

By Benton S. Bragg, CFA, CFP®



My father, Frank Bragg (aka Papa), conspired with my son Charlie (12) to convince my wife that Charlie needed a puppy for his birthday. Charlie gave us his birthday list back in July. At the top of the list: a puppy. Alice quickly informed Charlie that we were not getting another dog, especially a puppy. "We already have a wonderful dog [it's true] and there is no way we are doing that puppy thing again." Not finished, she reeled off a few more reasons why the idea of getting a puppy was a non-starter. "In addition to already having a dog, we have two goats, two pigs, two donkeys and a bunch of chickens to care for. You'll go to school, your father will go to work and I'll bear the brunt of caring for this puppy—taking him outside to potty every three hours, cleaning out his crate after he makes a mess, taking him to the vet for all those shots puppies need. He'll bark and whine all night, chew up everything we own and jump all over us and any visitor who stops by the house. We've been through all that enough times already. And who will train him? Now go think of something else to put on your birthday list."

That seemed to shut Charlie down for about a week but then one day he came home with two well-worn dog-training books, *Family Dog* and *Water Dog*, both classics written by Richard Wolters back in the sixties and still in print today. He held up his books and proceeded to make a remarkable argument for getting a puppy. "Everything I need to know is right here in this book, Mama. I will train this dog and I will take care of him. He and I will be best friends. And I need a friend. My brothers and sister will all be in college soon and I will need some company." And then the clincher, "Mama, I know you feel like we already did the animal thing with the dogs, the donkeys, the goats and stuff, but I was a baby when all of that happened. Just because I am younger shouldn't mean I miss out on the chance to have my own pet."

Alice was moved. "Wow, Charlie, that is quite an argument for a boy your age. How did you come up with all of that? And where did

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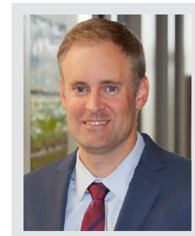
Market & Economy

By Matthew S. DeVries, CFA



Markets ended 2019 on a high note, with the S&P 500 rising 9.1% in the fourth quarter. For the full year, the S&P returned a whopping 31.5%. This was the second-best annual return of the decade and pushed the total cumulative return for the S&P for the last ten years to more than 255% (13.6% annualized).

International equities eked out even better returns than the S&P 500 in the fourth quarter. Particularly strong were emerging markets stocks, with the MSCI EM Index up 11.8% on a weakening US dollar. As shown in the table below, international equities have lagged US markets for several years now, so we are waiting to see if the recent outperformance becomes a lasting trend.

Fixed income held onto large returns in the fourth quarter even as the ten-year Treasury yield drifted higher from July's lows of 1.45% to end the year at 1.92%. The Barclays US Aggregate Bond Index had its best year of the decade on the heels of three rate cuts by the Federal Reserve, with an impressive 8.7% return for 2019. Minutes released from the last meeting show Fed governors are mixed on what to do next, which likely means rate changes are on hold entering 2020.

NO IMPENDING US RECESSION

The longest economic expansion in US history continued throughout 2019. Most estimates show a 2.3% growth

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Market Index Returns as of December 31, 2019

Index	4rd Quarter	1 Year	3 Years	5 Years	10 Years
S&P 500 (US Large Cap)	9.1%	31.5%	15.3%	11.7%	13.6%
Russell Midcap (US Mid Cap)	7.1%	30.5%	12.1%	9.3%	13.2%
Russell 2000 (US Small Cap)	9.9%	25.5%	8.6%	8.2%	11.8%
MSCI ACWI X-US IMI Net (Foreign Equity)	9.2%	21.6%	9.8%	5.7%	5.2%
MSCI EM (Foreign Emerging)	11.8%	18.4%	11.6%	5.6%	3.7%
Barclays Aggregate Bond	0.2%	8.7%	4.0%	3.0%	3.8%
Barclays Muni Bond	0.7%	7.5%	4.7%	3.5%	4.3%

Past performance is not an indication of future performance.

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you get those books?" It was then that we learned that Charlie had been huddling with his grandfather, hatching this plan to get a puppy. He said, "Papa gave them to me. Papa says every boy needs a dog. He said he had a dog when he was a boy and he said that Daddy had two beagles when he was a boy. And Papa said he would help me train him and that you wouldn't have to do anything."

Alice caved. Charlie got a black lab puppy. As Alice predicted, it has taken over our lives (especially hers). She's been a wee bit testy of late. Charlie has never been happier.

Thinking back on it, I must say that Alice made a convincing case for not getting a puppy. Prior to Charlie turning us both with his heart-string-tugging haymaker of an argument, she had actually won *me* over to her side. She was obviously scarred with memories of the last puppy we raised. This one will bring scars too. But we'll make it through.

Speaking of scars, the recent performance of the stock market might lead one to believe the scars of the financial crisis are finally fading. The market advance that began over ten years ago in March of 2009 has often been described as the "most hated bull market in history," so scarred were investors by the financial crisis when US stocks fell more than 55%. For years after the rally began, investors simply doubted that the market was on solid footing and expected another big crash.

Charlie Bragg and his black lab puppy.

Even as the economic expansion continued and the market rally reached new heights, it seemed that a healthy respect for risk kept overly-bullish emotions at bay and market valuations in check. But now investors seem to possess a bit more fortitude as they drive the market to one record close after another. Call it grit, call it guts, or, leaning heavily on my thesaurus, call it moxie or maybe even pluck. Whatever you call it, since the end of July when it seemed the pundits were trying to talk us into an economic recession, the market has jumped almost 14% and for the most part, it has been a one-direction rally. Price-to-earnings (P/E) multiples, price-to-book (P/B) multiples and other valuation measures show the market now trading above the average of the last 25 years.

In delivering this performance, the market has climbed the proverbial "wall of worry." As Matt DeVries points out in his year-end Market and Economic report, the US manufacturing sector remains weak, capital spending is expected to fall in 2020, the trade spat with China remains mostly unresolved, economic growth remains anemic in Europe and the UK, the Chinese economy continues to slow and US CEO confidence is low. In addition, we have tremendous political uncertainty in the US, first with the unresolved impeachment proceedings and even more significant, with the election just ten months from now.

And earnings? We always point out that stock prices are driven by corporate earnings so earnings must be up, right? Wrong. Quarterly S&P 500 earnings have been flat since the second quarter of 2018. While final numbers aren't in, estimates are that earnings only grew by about 1% for the full year in 2019. So, are the moxie, pluck and fortitude recently on display by investors proof that the scars of the financial crisis are healed, that respect for risk has gone bye-bye and that overly-bullish emotions now control the market? We think not. At least not yet. There is always the chance that we could experience a market melt-up where emotion does take over and where investors become irrational. But we don't think we are there yet.

Instead, we think the market is forecasting continued positive economic growth in the US, continued low interest rates and low inflation, reasonable earnings growth (mid-to-high single digits for the S&P in 2020), a slight pick-up in economic growth in Japan and Europe, a clearer path to Brexit in the UK, slightly more progress with China on tariffs, certainty regarding impeachment (Senate won't convict) and most important, a very strong US consumer.

I'll say a bit more on the consumer here since the consumer is the big driver of the economy, representing almost 70% of US economic output. With unemployment at a 50-year low of 3.5%, jobs are plentiful and wallets are bulging. Household net worth is at an all-time high while the consumer debt service ratio (consumer debt payments as a percentage of disposable income) is very healthy, thanks to low interest rates. Consumers are therefore confident. The 2019 holiday shopping season set records, and barring an unexpected shock like a dramatic escalation of the current clash with Iran, the spending is expected to continue into 2020.

The market is telling us that the positives outweigh the negatives, that economic conditions are pretty good. This is quite a different narrative than was generally accepted throughout the first six to seven months of 2019 and there is a good lesson in that. Investors entered 2019 believing the Fed was going to continue pushing interest rates higher. Recall that the market sold off dramatically in the fourth quarter of 2018 in response to the Fed's aggressive tightening. In an abrupt change of course, not only did the Fed not *raise* rates in 2019, they *lowered* rates three times. Last summer, investors worried that a messy Brexit, the trade war with China and the slowing economies of Europe and Japan would push the US into recession. This scenario didn't materialize and investors

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who brushed off dire warnings and gloomy headlines and remained invested were rewarded handsomely.

So, Benton, what about the elephant in the room? Oh yes, the election. It looms out there doesn't it? As we mentioned last quarter, it will be a turbulent year for investors—heck, turbulent for everyone, investor or not. I think the word Phillips Bragg used in his commentary last quarter was "shrill." Voices will be shrill in 2020. Obviously the outcome of the election will have repercussions for the market given the stark differences in the platforms of the two parties. We'll know more (and write more) in a few short months as the primaries narrow the field of Democratic contenders.

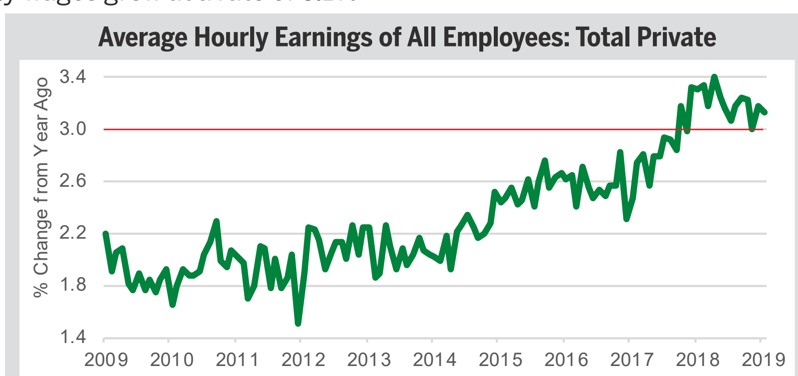
In summary, investor scars from the financial crisis have faded but still linger. Recent outstanding returns in the stock market reflect expectations that economic conditions will continue to be favorable for business. 2019 was an outstanding year for markets; don't expect a repeat in 2020. At Bragg we are rebalancing portfolios, recognizing that the future is unknown. The business cycle lives on and periodic market declines are a certainty. Sometimes they'll be scarring like that of the financial crisis but if we own an appropriate portfolio and maintain discipline we'll make it through those markets and be rewarded.

I better stop here and go take the dog out. Please let us know if you would like to discuss your portfolio or your planning. We greatly appreciate your trust in Bragg and wish you the very best in the New Year. ■

***Market & Economy**: Continued from page 1*

rate for GDP in 2019 and a projected 2.0% in 2020. While a bit uninspiring, those estimates show that most economists think we are still a ways off from the next recession.

The November labor report from the Bureau of Labor and Statistics showed the unemployment rate at 3.5%, a fifty-year low. The same report also indicated that wages have begun rising which may finally be signaling we are at or near "full employment"— meaning nearly everyone who wants a job has one. Hourly wages grew at a rate of 3.1% for the twelve months ending November 30. Meanwhile inflation was 2% for the same period. Fed governors watch wage growth relative to inflation very closely. Further accelerating wage growth could cause the Fed to resume pushing interest rates higher to head off inflation.



Source: U.S. Bureau of Labor Statistics, fred.stlouisfed.org

TRADE DISPUTES WEIGH ON MANUFACTURING

While much of the economy is stable and growing, manufacturing has struggled due to ongoing trade disputes that have hurt sales and caused domestic companies to delay new investments in property, plants and equipment. The Institute for Supply Management publishes a monthly report on manufacturing activity called the Purchasing Managers Index (PMI). December's PMI score was 47.2%. A score below 50% indicates contraction within manufacturing and this reading was the weakest since June 2009. While it only accounts for about 11% of US economic output and about 8.5% of total jobs, manufacturing tends to punch above its weight in the total health of the economy due to its more cyclical nature. Weakness in manufacturing is the primary reason some economists have worried that the US might tip into recession.

In Germany and Japan, where manufacturing accounts for a much larger part of the economy than in the US, each saw its PMI number fall into contractionary areas late in 2019. While neither is in a recession, they are much closer to recession than the US.

We may see a turnaround in manufacturing in 2020 as a result of a "phase one" trade deal reached last month between the US and China that will be signed on January 15. Perhaps more truce than deal, the US agreed to maintain previous tariffs of 25% on $250 billion worth of goods imported from China, to reduce duties to 7.5% on another $120 billion of imports and to put off additional tariffs planned for December. China agreed to increase imports of US goods by over $200 billion over the next two years while also promising to do more to protect foreign intellectual property and not manipulate China's currency.

While far from a final resolution, the deal removes much of the uncertainty we have dealt with over the past few years. Combine this accord with significant trade deals the US has signed with Japan, South Korea, Canada, and Mexico recently and it is hard not to see opportunities for growth in 2020.

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BRITISH VOTE YES FOR BREXIT (AGAIN)

The US is also likely to rework trade agreements with the United Kingdom and the European Union now that the path to Brexit is clear. Prime Minister Boris Johnson called for an early December election as a proxy for another referendum on whether or not Brexit should happen. Despite mixed polls before the election, the results were decidedly pro-Brexit as PM Johnson's Conservative Party won a resounding victory. It is now almost 100% certain that the UK will leave the EU on January 31.

While markets fell on Brexit headlines in the past, global markets rose following this most recent vote, presumably because it offers clarity in what has been a murky situation since the 2016 referendum. There are still questions about how the monumental split will go through but the three-and-a-half-year delay has given lawmakers extra time to prepare.

STOCKS OUTPACE FUNDAMENTALS

While stock prices took off in 2019, earnings remained little changed. Revenue growth has been offset by stagnating profit margins. As a result, valuations (price compared to projected earnings over the next twelve months) are back near the highest levels we have seen since the financial crisis. As the market is forward looking, the high valuations indicate that investors have high expectations for corporate earnings growth in 2020. We will be watching closely to see if earnings improve and justify these high prices.

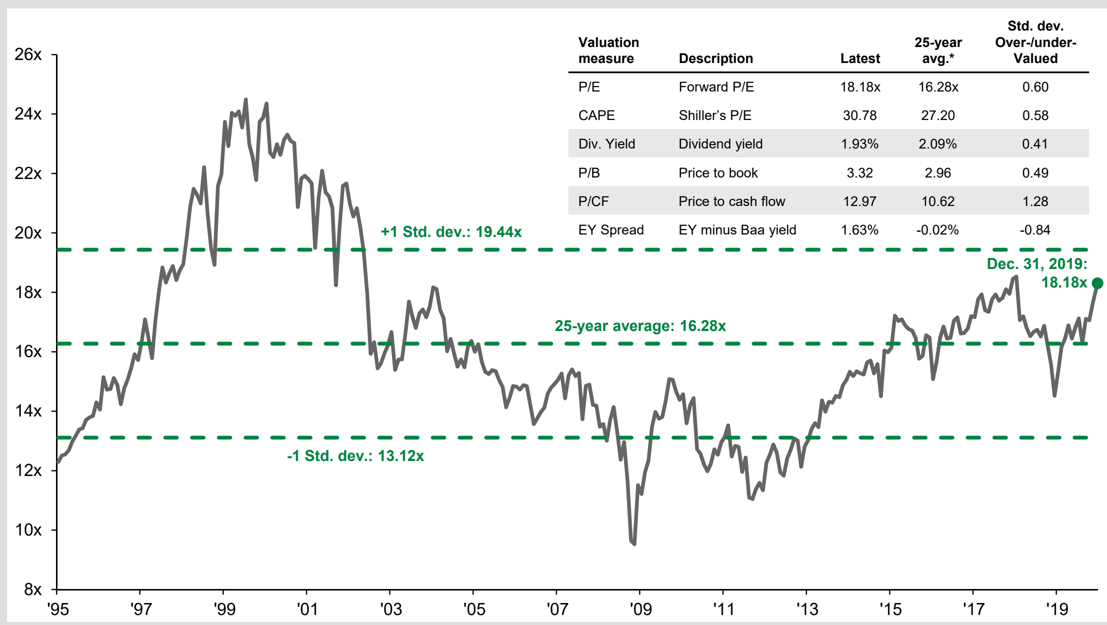
2019 WILL BE A TOUGH ACT TO FOLLOW

While 2019 wasn't a bad year for economic growth or earnings, it was a great year for investors. We may find that 2020 is a so-so year for investors but a much better year for earnings and economic growth as a result of the trade deals and Brexit certainty. Were this scenario to unfold, it would allow earnings to catch up with stock prices which would certainly make us more comfortable with valuations. In summary, compared to 2019, we think it makes sense for investors to lower their expectations for returns in 2020.

There are of course a few clouds of uncertainty on the horizon. One is the question of how events will unfold with Iran. Hopefully this situation will not mark a turning point toward significant hostilities. The other big uncertainty of course is the 2020 election. Will the Democrats nominate a moderate or a more liberal candidate? Will the House or Senate change leadership? While we are not qualified to answer these types of questions, we can say that little is likely to change economically between now and then. Falling stock markets in an election year could dampen an incumbent president's chances for re-election. Knowing this, President Trump is unlikely to do much to upset trade or any other part of the economy.

Like most years, we think it makes sense to be prepared for a bumpy ride. Please let us know if you would like to discuss your portfolio allocation. ■

S&P 500 Index: Forward P/E ratio



Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	18.18x	16.28x	0.60
CAPE	Shiller's P/E	30.78	27.20	0.58
Div. Yield	Dividend yield	1.93%	2.09%	0.41
P/B	Price to book	3.32	2.96	0.49
P/CF	Price to cash flow	12.97	10.62	1.28
EY Spread	EY minus Baa yield	1.63%	-0.02%	-0.84

*Source: Source: FactSet, FRB, Robert Shiller, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management. Price to earnings is price divided by consensus analyst estimates of earnings per share for the next 12 months as provided by IBES since January 1995, and FactSet for December 31, 2019. Average P/E and standard deviations are calculated using 25 years of IBES history. Shiller's P/E uses trailing 10-years of inflation-adjusted earnings as reported by companies. Dividend yield is calculated as the next 12-month consensus dividend divided by most recent price. Price to book ratio is the price divided by book value per share. Price to cash flow is price divided by NTM cash flow. EY minus Baa yield is the forward earnings yield (consensus analyst estimates of EPS over the next 12 months divided by price) minus the Moody's Baa seasoned corporate bond yield. Std. dev. over-/under-valued is calculated using the average and standard deviation over 25 years for each measure. *P/CF is a 20-year average due to cash flow data availability.*