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EQUITY MARKET UPDATE

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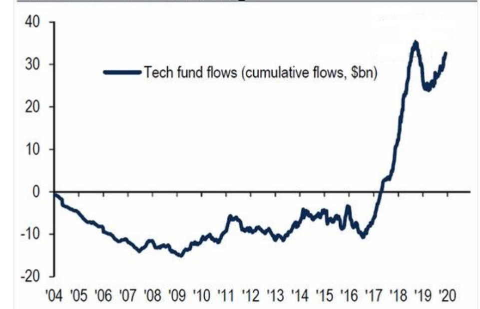
Stocks rallied sharply after President Trump announced his administration had reached a "Stage 1" trade deal with China, and British elections delivered an outcome assuring its exit from the European Union. With these major geopolitical concerns simmering down, along with accommodative actions from the world's central banks, investors bet the worst of the economic slowdown had passed and the new year would usher in a new wave of global growth. The December gains capped off the best year for stocks since 2013.

Large Cap Stocks Reach New All-Time Highs

The S&P 500 continued its rally off the August lows, and it hit a new all-time high just before the year ended. The index advanced 3.01% for the month. For the fourth straight month, low valuation cyclical stocks outperformed the overall index, while the crowded defensive trades lost ground. The S&P 500 finished 2019 up 31.48%, its best showing in six years. While the return was impressive, only three economic sectors outperformed—technology (+50.29%), communications (+32.69%), and financials (+32.13%). The jump in tech stocks was so strong that it accounted for 31% of the index's total return, with nearly half of that coming from Apple (+82.39%) and Microsoft (+57.92%). Despite technology's large influence on results, 90% of the stocks within the S&P 500 had positive returns for the year.

The results for the Dow Jones Industrial Average were not as strong as the S&P 500. The Dow gained 1.87% for the month. Year-to-date, the Dow was up 25.34%. Weak performance from Boeing, 3M, and Walgreens hindered the index's return all year.



Once again, the NASDAQ had the best monthly return among major American indexes gaining 3.64%. For the second straight month, 25% of the index's performance came from the 9.88% jump in Apple, the largest name in the index. The NASDAQ was the leader in 2019 with a total return of 36.74%. As we have stated before, the performance from major tech companies has been the single largest factor in describing total return differences among equity portfolios over the last four years.

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Mid and small-sized companies had another solid month with the S&P 400 Mid-Cap and S&P 600 Small-Cap indexes gaining 2.81% and 2.99%, respectively. This has largely been the result of interest rates climbing from their August lows and spreads widening among 2-year and 10-year US Treasuries. We have written for months that both indexes have a large exposure to banks whose profits expand when interest rates rise. In 2019, mid-cap and small-cap stocks were up 26.17% and 22.74%, respectively.

International Stocks Jump on Trade-Deal News and British Election Results

Economic data in foreign markets remained weak in December; however, signs continue to point toward stabilization. News of an upcoming trade deal between the US and China, along with a potential resolution on Brexit, pushed international stocks higher. MSCI EAFE increased 3.27% in December, while MSCI Emerging Markets zoomed 7.35%. For the full-year, MSCI EAFE gained 22.77%. The European stocks within this index had their best showing since 2009. Meanwhile, MSCI Emerging Markets returned only 18.63% in 2019 and was the weakest among major equity indexes. A strong US dollar and an economic slowdown in China weighed on results.

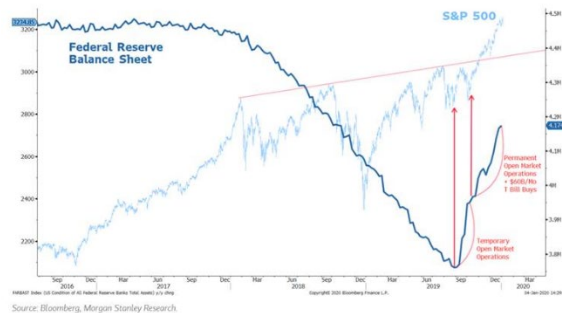
Other Asset Classes Also Rally in 2019

The past year was a rarity in which asset classes outside of stocks also posted their strongest returns in years. Gold gained over 18%. US Treasury bonds with maturities longer than 20 years returned an astonishing 14.12% as interest rates declined. Even West Texas Intermediate Crude (WTI) jumped 25.59%. According to *The Wall Street Journal,* 2019 was the first-time stocks, Treasuries with long maturities, gold, and oil each had an annual return more than 10% since 1984!

Much of this has to do with continued central bank intervention. Throughout the year, we wrote about the Fed's U-turn on interest rates. They began the year talking about additional hikes, but they quickly reversed course as economic data deteriorated. They instead cut interest rates three times for a total of 75 basis points. The weak economic data and lower rates sparked the rally in bonds. The ECB joined the Fed by cutting their interest rates further into negative territory, and they announced the resumption of quantitative easing through a 20 billion euros a month bond purchasing program. Finally, the Fed re-entered the market place by providing almost $500 billion in liquidity to support the repo market. This program caused the Fed to once again expand their balance sheet. The boost in liquidity not only sparked a rally in gold, but it was also a tremendous help to the stock market.

Source: Goldman Sachs, Bloomberg

As we enter 2020, central banks are likely to continue these accommodative actions. Manufacturing globally is near recession, and US GDP growth is around the 2% level we have seen since 2000 with limited inflation. Collectively, the Fed, the ECB, and the Bank of Japan are expanding their balance sheets by over $100 billion a month. This is the largest expansion of central bank balance sheets in three years. Finally, the People's Bank of China (PBOC) cut their required reserve ratio by 50 basis points which should unleash $115 billion worth of reserves into the Chinese financial system per research from Morgan Stanley.



Source: Bloomberg, Morgan Stanley Research.

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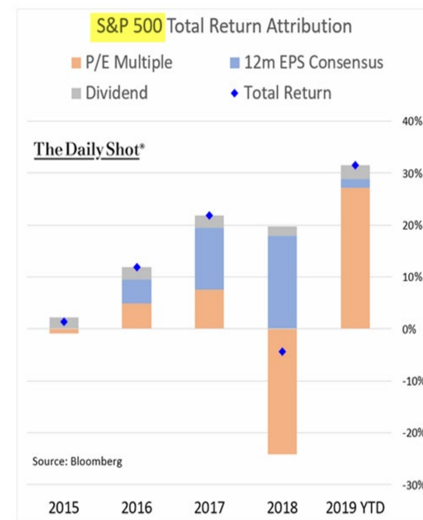
Big Rally on No EPS Growth Makes Market PE Highest Since Early 2018

The gains in December increased the forward PE ratio on the S&P 500. Currently, the index trades at 19.1x forecasted 2020 earnings, its highest reading since January 2018. This is an increase from the 14.90x forecasted earnings one-year ago, and it is above the 10-year and 30-year average of 15.16x and 15.82x, respectively. With earnings growth nonexistent in 2019, the entire rally in stocks came from PE multiple expansion.



Volatility also collapsed. The CBOE Volatility Index (a measurement of fear) fell 50% in 2019, its largest annual decline ever. We enter 2020 with volatility at the bottom of the range for the past two years. Merrill Lynch's Investor Sentiment Indicator (their proprietary gauge to measure risk taking) shows the highest level of exuberance since January 2018, despite elevated valuations.

Finally, analysts continue to revise downward their 2020 earnings growth forecasts. Currently, they are looking for 9.6% earnings growth. As we have stated numerous times, that will be difficult to achieve, even with easy comps, without an uptick in economic growth from the trade deal.

Our Outlook and Strategy

The US economy is on firmer footing compared to other countries around the world; however, we have seen weakness in manufacturing, services, and inflation. The state of the consumer remains strong as the labor market continues to add jobs. Most data points in our proprietary economic checklist indicate the US economy is in the late stages of the economic cycle. With sluggish economic growth and stocks trading well above their historical averages on a PE basis, it is hard to imagine stock PE multiples expanding much further. We expect the stock market to experience higher bouts of volatility with any additional gains coming from earnings growth and improving geopolitical conditions.

We had a successful 2019 with composite returns for our Equity Income and Core styles exceeding the S&P 500. We were quiet on the trading front most of the year. The majority of our trades in 2019 took place during the first quarter when we used the stock market rally to trim earnings risk from our portfolios. With many of our names trading at all-time highs with elevated PE ratios, we plan to trim some of our winners from 2019, especially those that carry a large weight within portfolios. The proceeds will be reinvested into names with lower PE ratios and possibly higher dividend yields that are able to withstand overall market volatility without sacrificing financial quality or exposure to transformative themes.