Capital Markets in 2019: A Positive Spin by *Rota Fortunae*[1]

Capital markets achieved results during calendar year 2019 that not only widely exceeded virtually all expectations going into the year but that were also among the best one-year outcomes of the past two decades. Coming on the heels of a confidence-shaking global equity market sell-off in late-2018, these exceptional outcomes once again demonstrated the unpredictability of both macro-economic trends and of investors' behaviors. This very favorable "spin" of capital markets' *Rota Fortunae* (Wheel of Fortune) in 2019 capped a decade-long stretch of mostly beneficial market outcomes that seemed wholly unlikely at the start of the 21st Century's second decade.

TOP CAPITAL MARKETS STORIES OF 2019

How the long arc of capital markets history perceives the relative significance of events and outcomes from a single 12-month period is never immediately obvious, and that is certainly the case with respect to 2019. Surely, historians will recall the US Federal Reserve's January 2019 decision to curtail its more restrictive recent monetary policies (i.e., a net +225 basis point increase to the Fed Funds rate between December 2016-December 2018) and its subsequent three rate cuts during the year. Market historians will likely find future opportunities to cite the briefly inverted yield curve (e.g., yields on 3-month Treasuries higher than 10-year Treasuries) of June-September 2019 as either an accurate signal or inaccurate warning of future economic distress. Only time will tell. What can never be known: the extent to which the Fed's about-face and rate cuts ultimately altered the US economy's growth trajectory.

Likewise, it is too soon to gauge the long-run economic implications of the Trump Administration's aggressive trade policy negotiations with China and its tinkering of policies with two of the US's largest partners, Mexico and Canada, and with others. The business uncertainties created by these policies had a direct impact on select US businesses and industries during 2019; having built-out global supply chains across the last decade, many needed to start re-thinking their business models. Amid such uncertainties, a pullback on business investment spending (on structures; on equipment) cut into the rate of economic growth but did not derail the record (now 10 ½ years long) US economic expansion.

Looking more broadly, China's related economic slowdown had a ripple effect on other major global economies, most notably Germany. With most major world economies growing at just

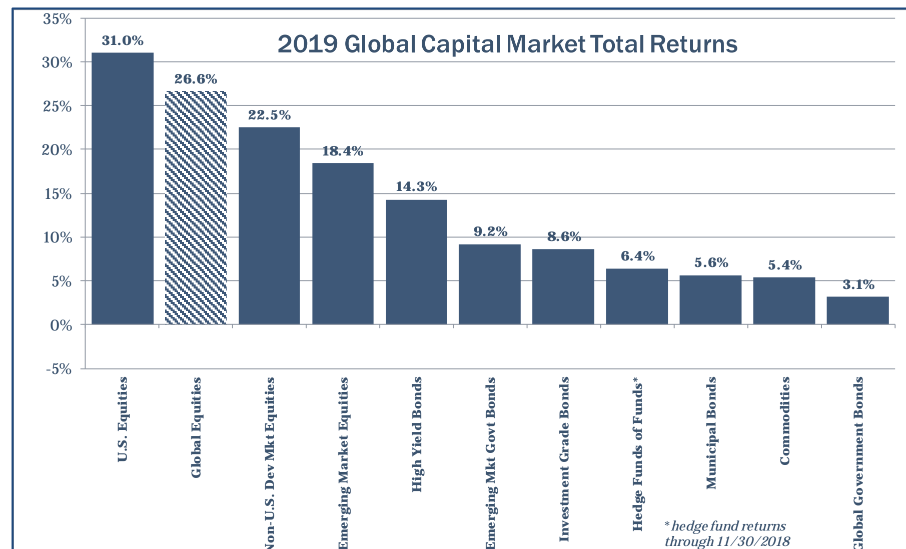
[1] *In medieval times, Rota Fortunae (Latin for "Wheel of Fortune") was a metaphor for fate; at its extremes the wheel's predicted outcomes could swing between abject misery and great fortune*

above stall speed, global central banks' accommodative monetary policies continued to mean low-to-negative interest rates across most of Europe and in Japan. More economists and policymakers are starting to express doubts about the long-run efficacy of keeping short-term interest rates near or below 0%; in late-December, Sweden's central bank took what was billed as a symbolic gesture to move away from a *negative interest rate regime* by raising its short-term rate from -0.25% to 0%. Whether other central bankers eventually follow their lead – putting an end to near decade-long experiment of using negative interest rate policies as a means of stimulating economic growth – could become a story of import in 2020 or beyond.

Lastly, the UK held two national elections in 2019 as it struggled to find a politically acceptable means of executing on its June 2016 BREXIT vote. The Conservative Party's overwhelming victory in the second of these elections would seem to have (finally) put to rest any possibility of a follow-on national vote whether to proceed with the 2016 mandate. A negotiated British exit from the European Union during 2020, therefore, is now likely. The uncertain economic and capital market (not to mention the political and cultural) implications of this eventuality is a multi-year story for historians to ponder.

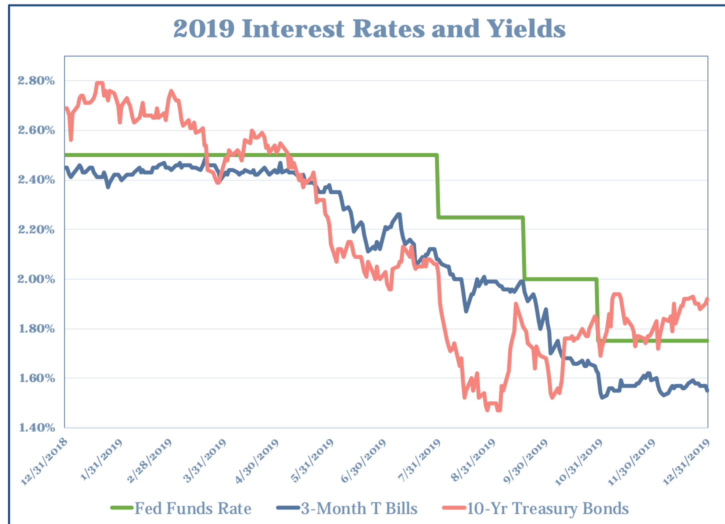
CAPITAL MARKETS: 2019 RESULTS

In retrospect, the change of Federal Reserve policy starting in June *trumped* all other macro-economic trends and events during 2019. With fewer worries that higher interest rates would spell an end to the US economic expansion, businesses continued to add workers to their payrolls and an already low rate of unemploy-ment trended lower (t0 3.5%). Job security helped support high levels of consumer spending, and greater consumer confidence combined with a paucity of obvious alternatives for savings and investments resulted in higher prices being paid for bonds and stocks alike. The consequence: total returns across most capital markets that far exceeded expectations and were well-above average.



Fed Policy, Bond Markets, and Fixed Income Securities

As shown in the nearby graph depicting interest rate trends, short-term yields (e.g., 3-month Treasury Bills) declined on balance during 2019, particularly after the Fed began cutting rates in June. This decline rewarded borrowers with loans tied to such benchmarks but (once again) penalized savers. Yields on longer maturities declined for much of the year; after peaking at a yield of about 3.2% in late 2018, the 10-Year Treasury bond yield declined to about 1.5% by September. Thereafter, waning concerns about the pace of US economic activity pushed yields somewhat higher and caused long-bond prices to decline somewhat.



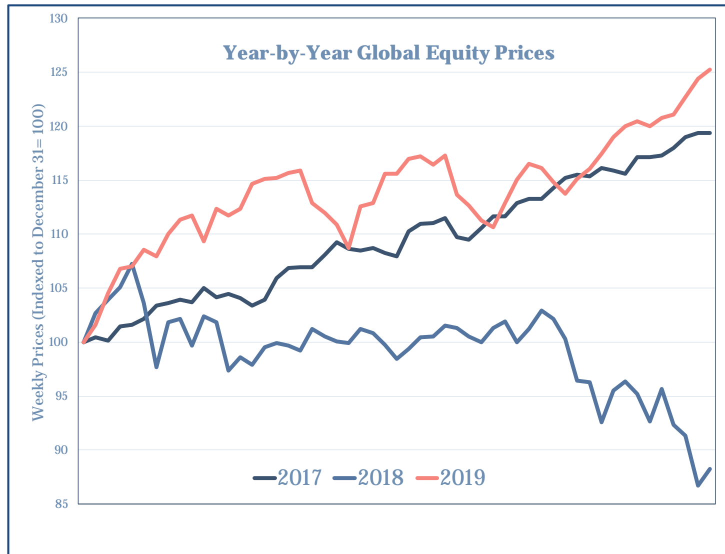
Falling bond market yields were not just an unexpected 2019 development, they were also a windfall for investors' fixed income portfolios. Aided too by tightening credit spreads (the incremental yield paid to investors for taking on the risk of lending to corporate and other non-government borrowers), the taxable bond market returned +8.7% (Bloomberg Barclays Aggregate Bond Index) last year. This outcome was not only leaps-and-bounds better than the +0.1% return for all of 2018, it was greater than the +6.9% *cumulative* total return produced on taxable bonds for the four-year period 2015-2018.

Lower market yields likewise permeated the tax-exempt (muni bond) market, which was also the beneficiary of tight supply conditions (reduced borrowing by the various state and municipal issuers that comprise most of this asset class) and elevated demand (individuals seeking to maximize their after-tax incomes). The net result: a 2019 total return of +5.6% (Bloomberg Barclays 1-10 Year Index), compared to +1.6% in 2018.

Equity Markets and Investments

Last year was one of comparatively smooth sailing for global equity markets, particularly in comparison to 2018. As shown in the accompanying chart, prices generally exhibited less volatility than the prior year, when global equities sold off -11% in mid-February then mostly rallied toward their earlier highs before a -17% correction that ended on Christmas Eve. The

year 2019 more closely resembled 2017, a year that established itself as *the paradigm* of positive global equity market price performance with positive total returns in every month (the first such outcome in the 30-year history of the MSCI ACWI global market benchmark).



The greatest surprise about the performance of equity markets in 2019 – particularly the US market – was how little attention was paid to earnings trends. The S&P 500 Index, for example, achieved record high EPS in 2018 (driven higher, in part, by tax law changes that reduced most companies' taxes) and its constituent member companies were projected to produce additional earnings growth of nearly 11% in 2019. Although there were expectations that disappointing reported earnings across the year's first half would be more than offset by improved results across the balance of the year, data currently suggests that overall 2019 EPS are at best likely to be little changed versus 2018.

Ordinarily, a rational expectation might be for market prices to decline in the face of earnings shortfalls in comparison to expectations. Indeed, this reaction function continued to hold true for some individual issuers (i.e., share prices that sold off immediately after unfavorable quarterly earnings announcements) in 2019. But as shown in the table below, the market mostly ignored disappointing earnings last year; in effect, investors pushed valuations higher by paying more for less earnings.

Contributors to S&P 500 Price Change (2019)

Changes In	1st Qtr	2nd Qtr	3rd Qtr	4th Qtr	Year
Estimated Earnings	-2.3%	-0.1%	-1.0%	-0.5%	-3.8%
Valuation	15.6%	3.9%	2.2%	9.0%	34.0%
Price	13.0%	3.8%	1.2%	8.5%	28.9%

For example, S&P 500 Index valuations rose from a post-December "sale price" of 14.7x as the year began, traded within a band of 17.0x to 18.2x through the summer and early fall, then broke out of this range to finish 2019 at a Price/Estimated Earnings of 19.8x. In this example, more than 100% of the Index's total price appreciation (+28.9%) was the result of higher valuations.

Perhaps not surprisingly, this 2019 phenomenon of rising market prices in the face of flat-to-uninspired earnings growth was not unique to US large cap stocks or the growth stock component thereof. Valuations of US small cap stocks rose +49%, and double-digit price

appreciation in other global equity markets was almost entirely attributable to rising valuations i.e., P/E ratio increases of +24% and +29% in Other Developed and Emerging Markets, respectively).

Commodities

A broad basket of commodity investments (e.g., diversified positions in precious and industrial metals, in oil and other energy, and in agricultural products) produced an overall total return 0f +5% last year. Of greatest interest to investors generally: the price of crude oil traded within a band of $50-$60/barrel for much of 2019, finishing the year at the top end of this range and +35% higher than at year-end 2018. Gold prices rose sharply (from $1280/ounce to $1550, +21%) during the summer months, finishing the year at the highest price since early 2013.

Alternative Strategies

Alternative investment strategies (aka hedge funds) largely participated in the rally across global capital markets in 2019, with hedged equity, equity-focused, and event-driven strategies leading the way in this segment of the investment universe. Broadly diversified Fund of Funds hedge programs produced positive absolute returns in excess of +6% for the year, but their relative performance lagged both global equities and taxable fixed income securities. Top performers in 2019 tended be to directionally long-biased and growth equity funds, while the 2018 beneficiaries of that year's substantially more volatile markets (i.e., non-directional, market neutral, and arbitrage strategies) were laggards this past year.

Private Equity

Private equity markets enjoyed a banner – but not record – year of transactional activity in 2019. The asset class and major segments therein generated their share of capital markets headlines. Notable Initial Public Offerings (IPOs) last year included Saudi Aramco's record-breaking $25 billion equity offering, the disappointing market debuts of Lyft and Uber, the successful launch of Beyond Meat, and the cancelled IPO for WeWork. Beyond the headlines, total IPOs last year ($60 billion) were just shy of 2018's total, and investment "exits" from venture capital and buyout funds overall reached a near-record $800 billion. Industry fundraising continued at a torrid rate and, paced by the recycling of an ample amount of capital returned to investors from their earlier PE commitments, appears to have set a new high capital raise of over $300 billion in 2019.

THE 2010s: AN INVESTMENT RETROSPECTIVE

It is a bit hard to fathom that the 21st Century just wrapped-up its second decade. For some of us, memories of the potential for a Y2K economic and financial market crisis (arising out of

concerns that critical technologies would cease to function correctly as calendars moved from 1999 into 2000) still seem fresh. So, too, the prolonged post-Dot Com era stock market correction Of 2000-2002 and the even worse Great Recession and attendant stock market collapse of 2008-2009. These two long-tailed events produced a "lost decade" for investors (with annualized global stock market gains of only +1%) from 2000-2009. And as the 2010s got underway, there was widespread concern that it could take a full decade for the economy and capital markets to recover from high unemployment (then approaching 10%) and lower housing prices (-23% below their pre-recession highs).

Ten years ago as another new decade began, in a similar annual report written for clients we noted with some optimism that *"firming economies and stabilizing unemployment rates have led many economists to conclude that we have already experienced the worst of the Great Recession.*" Capital markets had already begun anticipating an improved global outlook: US stocks rallied to return +28% in 2009, other developed market equities were +23%, and Emerging Markets rang-up an unprecedented +79% one-year return. Assisted by the heavy hand of global central bankers, *Rota Fortunae* – the Wheel of Fortune – was fortuitously starting to spin in the direction of providing "much better things" for investors across the 2010s.

The data – and the final verdict – for the 2010s decade are now in. Thankfully, global capital markets survived a series of challenges (too many and too stressful to recount herein) and did not record a second consecutive lost decade. Instead, US and global equities produced annualized total returns of +13% (Russell 3000 Index) and +9% (MSCI All Country World Index), respectively. The widely followed and technology stock-laden S&P 500 Index logged a similarly robust annualized gain of +13.5%, versus a -1.0% annualized loss (-9% cumulative) across the prior decade. An impressive result, but not a record: returns in the 1980's and the 1990's still reign supreme in the annals of recent capital markets history. And although challenged by persistently low interest rates and bond market yields, taxable bonds (+3.7% annualized returns) and tax-exempt bonds (+3.2%) eked-out modest real returns relative to similarly low levels of inflation (which averaged just 1.6% annually) during the 2010s.

CAPITAL MARKETS: 2020 OUTLOOK

In that January 2010 report to clients kicking off a new decade, we observed that investors ended 2009 with *"dramatically different mindsets than when the year began*", a phrase that we could very easily have reprised annually thereafter. That was certainly the case last year: worries that tighter Fed Policy (and attendant higher US interest rates) in 2018 would tip the economy into a recession dissipated after the Fed reversed course in January and months passed without a material slowdown. So too, concerns that a trade war with China would

further escalate, with adverse implications for rates of US and global economic growth. Investors largely put these worries aside toward year-end, despite only prospects of a Phase I trade deal sign-off in early 2020 to fall back upon. The takeaway: developments within a single year often produce outcomes that vary markedly from initial expectations and predictions.

So, even though optimism reigns across global capital markets as we begin the next decade – the 2020s – we caution that starting bond market yields will make it hard for bond markets to replicate even the modest annualized returns of the 2010s, much less the equity-like outcomes they produced in 2019. Likewise, elevated global equity valuations (particularly those in the US) are a strong argument against a repeat of 2019's stellar one-year outcomes.

Averages: Economy and Bond Market Yields

Decade	1990s	2000s	2010s	**Recent^**
Real US Economic Growth	3.2%	1.9%	2.3%	**2.3%**
Consumer Inflation	2.4%	1.8%	1.6%	**1.6%**
Unemployment Rate	5.8%	5.5%	6.3%	**3.5%**
Fed Funds Rate	5.10%	2.98%	0.73%	**1.75%**
Treasury Bill Yield	5.02%	2.78%	0.56%	**1.55%**
10-Year Treasury Yield	6.67%	4.46%	2.41%	**1.92%**
Muni Bond Yields	4.95%	3.46%	1.80%	**1.40%**

^Lastest reported data as of 12/31/2019

Annualized Total Returns

Decade	1990s	2000s	2010s	**Recent***
Taxable Bonds	7.7%	6.3%	3.8%	**8.7%**
Tax-Exempt Bonds	6.9%	5.1%	3.2%	**5.6%**
US Equities	15.9%	-0.2%	13.1%	**31.0%**
Global Equities	10.4%	1.0%	9.3%	**26.6%**

**Returns for 12 months ended 12/31/2019*

The Macro-Economic Environment

Domestic and global political developments seem likely to dominate substantive economic policy changes in the US Presidential election year 2020, though the two spheres will certainly intersect often between now and November. History supports the thesis that short-run market prices may react to outcomes of the former (recall market price volatility immediately prior to and following the 2016 election). But from a portfolio management perspective, paying attention to election-related noise – and repositioning asset allocations in anticipation of a particular outcome – is a strategy to be avoided. Rather, understanding and embracing expected long-run economic trends (e.g., economic growth rates, interest rates, and corporate profitability) should continue to be investors' primary focus in 2020 and beyond.

With the current US economic expansion having surpassed the length of all prior post-war expansions, it is entirely rational to expect a recession at some point in the decade ahead. Some economists argue that an occasional downturn – though not one as gut-wrenching as the Great Recession of 2008-2009 – is healthy for the long-term success of an economy. But presently, there is nothing about the tepid current economy (with its attendant modest rates of wage growth and inflation) that suggests elevated risks in 2020. Recent political claims to the contrary, current GDP growth is consistent with the overall annualized rate of growth experienced across the entirety of the post-2008 expansion (i.e., +2.3%). And, reflecting the

demographics of an aging and more slowly growing population, the pace of US growth has tailed-off from the more robust recent decades of the 1980s (+3.1% annualized growth) and 1990s (+3.2%). Our projections for the decade ahead (without taking into consideration a potential recession at some point therein): real GDP growth of +2.1% annualized. We see no reason to think that economic growth in 2020 will deviate meaningfully from this projection; accordingly, US economic growth next year is likely to be somewhat slower than in 2019.

US Bond Markets and Fixed Income Portfolios

There is a possibility, but by no means a certainty, that the Federal Reserve decides that an additional -25 basis point rate cut (to 1.50%) is needed by mid-2020 to keep the expansion afloat. Thereafter, inaction seems the most likely monetary policy course; the Fed has historically sought to avoid changes as Presidential elections approach and we see no reason to believe it will behave differently in 2020.

Without much movement of rates at the short end of the yield curve, the overall outcomes that investors can expect from their bond portfolios in 2020 should approximate the current yield-to-maturity of those portfolios. The overall taxable bond market (Bloomberg Barclays Aggregate Index) was yielding 2.30% at the end of 2019; for tax-exempt bonds (Bloomberg Barclays 1-10 Year Municipal Bond Index) the yield was 1.40%.

Corporate Profits, Profit Margins, and Valuations

As discussed above, earnings reported by US companies were little changed in 2019; trailing 12-month EPS for the S&P 500 Index were $150/share through late-December compared to $152 as 2019 began. Recent consensus analyst estimates project that earnings will grow an additional 11% in 2020. If these estimates are accurate, then this broadly referenced benchmark of the US stock market was trading at 18.5x estimated 2020 earnings at year-end. The valuation is high relative to the past 25 years (median Price-to-Estimated EPS of 14.8x) and compared to our forward-looking estimate of US equity market fair valuations (16.1x).

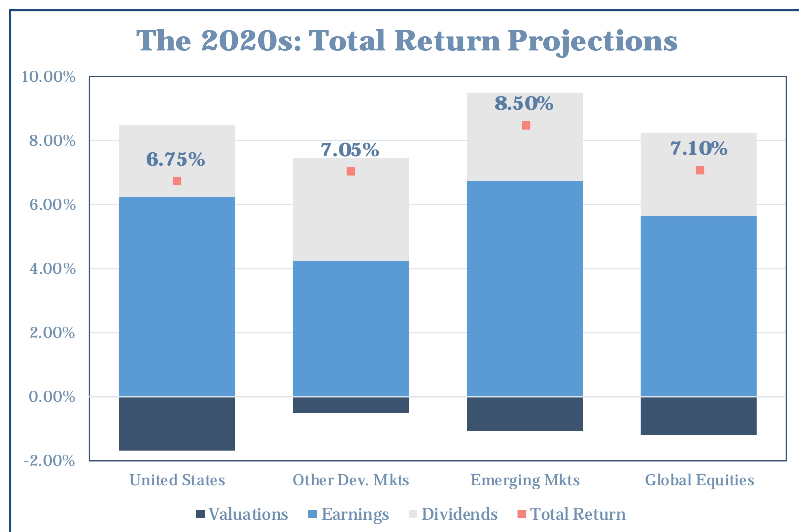
Although we claim no particular proficiency for deriving accurate short-term earnings estimates across broad swaths of the market (much less industries and companies therein), current consensus earnings estimates and the valuations being applied to them both seem overly optimistic given an economy that is projected to slow modestly. The profit margins implied by these earnings estimates – still high in 2019 relative to historic norms – would seem difficult to achieve this late within an economic cycle. Investors ignored earnings shortfalls in 2019; we worry that markets will be less forgiving of disappointing corporate profits in 2020.

Neither the US economy nor the companies listed on its stock exchanges operate in isolation from the balance of the world. Other major (non-US economies) grew more slowly than the US

in 2019 and their growth is expected to trail again in 2020. Analysts' non-US company earnings estimates for all of 2019 (virtually flat versus 2018 but with a big year-end bump) and 2020 (additional growth of +7%) also seem optimistic. Though year-end valuations in these markets were also generous (at 17.3x and 14.4x 2019 and 2020 earnings estimates, respectively), these markets continue to reflect less optimism than the US and are trading at a smaller premium than both their longer-term historical (14.9x) and our forward fair (14.2x) valuations. Wide differences across Emerging Market equities (MSCI's commonly used benchmark for which is comprised of 26 disparate worldwide economies, comprising just 12% of global equity market capitalization) make for even more problematic earnings estimations. At year-end, in aggregate these markets were valued at 14.6x trailing earnings, not quite as far removed from their long-term average (13.5x) and our forward fair value (12.1x) estimate.

Global Equity Market Returns

In last year's similar *Annual Market Perspective*, we went to some lengths to project and illustrate the range of possible one-year outcomes (a low of -7.4% if earnings were flat; +21.3% if earnings met optimistic forecasts and valuations increased to 17x) that at the time seemed most probable for US stocks. Happily, for investors our best-case estimate was not optimistic enough. In defense of these inaccurate projections, we did espouse a view as indisputable and uncontroversial then as it is today: *"the market's short-term price reaction to earnings trends is unpredictable".*



We have long been more comfortable projecting annualized returns across a longer investment horizon (e.g., 5-10 years) than for a 12-month period, given the tendency of the key inputs thereto (earnings growth, dividend payments, and changes in valuation) to normalize over time. The chart at right illustrates our most recent 10-year total return projections (and the expected contributors to these returns) for overall global equity markets and for major segments therein across the 2020s. There will, of course, be substantial deviations from these projections across short-term (e.g., 12 month) measurement periods. We think using such estimates – not short-

term predictions made by us or any other investment professionals that are unlikely to entirely hit the mark – should always inform any asset allocation decisions that are made with respect to targeting the returns produced and managing the risks taken within any investment portfolio.

SUMMARY AND CONCLUSIONS

It was a great year – and a very good decade – for capital markets. Investors went into the 2010s with both psychological and balance sheet scars produced by the Great Recession. Collectively investors' portfolios exited the decade with a flourish, enjoying a year in which investments produced several years' worth of expected gains. The next decade will, of course, produce its own set of uncertainties (those proverbial *unknown unknowns* that have plagued geopolitics and capital markets alike across the years) and short-term market returns that vary widely from expectations. Accordingly, our investment counsel for the year and for the decade ahead is no different than in the past. Maintain a long-term perspective. Own a broadly diversified portfolio that takes only those risks required to deliver on current and longer-term financial needs. And do not react to periodic wide swings of *Rota Fortunae* toward either despair or exuberance.

INVESTMENT STRATEGY TEAM
JANUARY 7, 2020

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