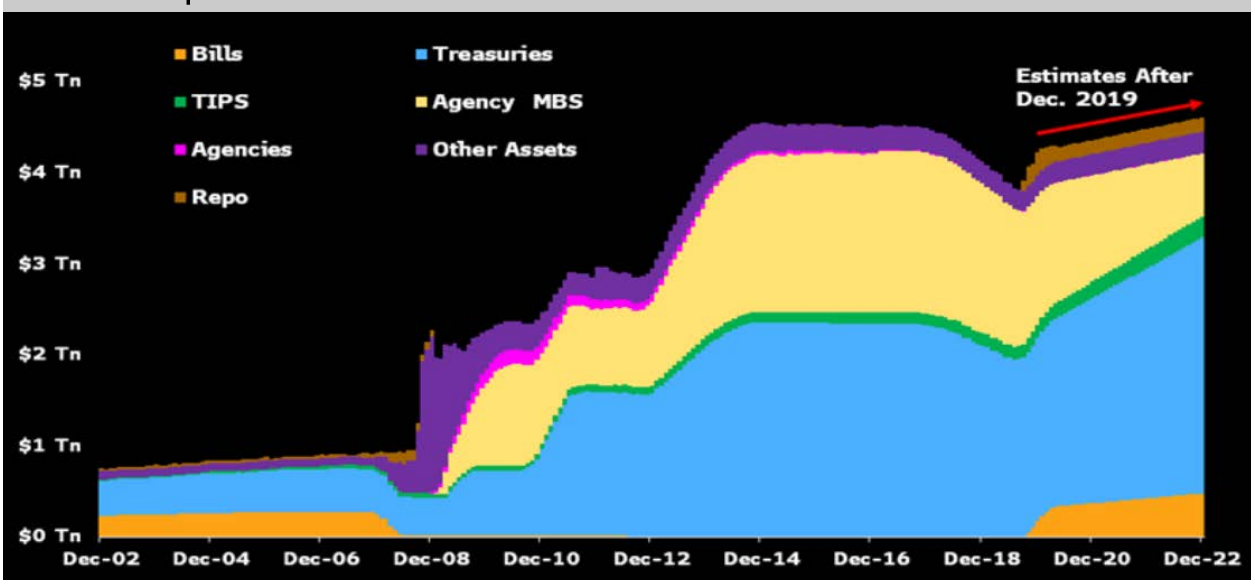
Market Review

December 2019

US equity performance was very strong during the fourth quarter, capping off the strongest year for the market since 2013. US equities outperformed most markets in both 2019 and for the last decade, including Europe, Japan and emerging markets. Within US equity markets, growth has been the winning style category, having outperformed again in 2019 and for eight out of the last 10 years. The outperformance is in part due to the very strong performance of the technology sector. Technology stocks in the S&P 500 returned close to 50% in 2019 and 335% over the last 10 years. In addition to growth stocks, another trend has been a gravitation by investors to the larger market-capitalization stocks. The S&P 500 returned 31.5% in 2019 versus 25.5% for the Russell 2000 index, and for the last decade the respective returns are 257% versus 206%. The S&P 500 saw outsized benefits from blue-chip, technology-oriented stocks, like Apple and Microsoft, for both the year and the decade.

The fourth quarter performance was a mirror image of the sharp underperformance that was felt at the end of 2018. The market was able to enjoy a surge in liquidity from the Federal Reserve, rather than the balance sheet contraction that was so damaging to equity markets last year. Other central banks are following suit. The Fed, Bank of Japan and the ECB are collectively expanding their balance sheets by meaningful amounts on a monthly basis. The Fed is also supporting liquidity through their overnight repo operations. This excess liquidity is keeping volatility low along with supporting asset prices.

Fed Asset Expansion



Source: Bloomberg

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The US equity market seems unfazed by macro uncertainty. While market volatility has remained low, there is no shortage of economic and geo-political events that could influence returns in 2020. For one, the US Presidential election introduces a binary-outcome event that could shape policy for years to come. Two, while the trade deal with China seems to be moving forward in a constructive manner, at least for phase one, the narrative could change quickly, which we have experienced in the past. Other events investors need to be mindful of include the Brexit fallout, as well as the potential for escalating tension in the Middle East.

On a positive note, the US economy remains sound, supported by one of the strongest consumer backdrops in history. Unemployment levels are near 50-year lows, consumer net worth has surged alongside asset prices (i.e., stocks, real estate), and interest-rates remain at accommodative (low) levels. While investors will be watching to see if the current economic expansion, one of the longest in our history, extends into 2020, trends seem favorable for now, particularly as we anniversary several factors that depressed results in 2019, namely tariffs, the General Motors strike, and production shutdowns at Boeing (related to the 737 Max).

Corporate profits are set to rebound this year, following disappointing results in 2019. Earnings per share for the S&P 500 companies are projected to advance by 9%-10% in 2020. This compares to estimated growth of about 1%-2% in 2019. Profit growth stalled in 2019 due to a variety of factors, including a slowdown in manufacturing activity (partly the result of tariff uncertainty), higher labor costs, and depressed commodity prices. Cyclical companies (i.e., technology, energy, basic materials, etc.) are expected to experience the biggest gains in profitability in 2020, as global inventories start the year at relatively low levels, commodity prices have stabilized, and foreign economies look poised to inflect positively.

The set up for US equities appears positive on the heels of strong returns in 2019. That said, geo-political headlines have the ability to shake up markets. With the S&P 500 trading at around 18.5x earnings, the market is vulnerable to negative news from a valuation stand point. As always, we remain focused on identifying stocks with relatively attractive valuations which we believe have the ability to exceed consensus expectations.

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