Market Review & Outlook

January 2020

The stock market's remarkable levitating act continued unabated during the 4th quarter. Indeed, the rally seemed to intensify in the year's final quarter, perhaps because the economic data was not trending as uniformly negative as seemed to be the case in the 3rd quarter. The surge into year-end meant that the S&P 500 finished 2019 with a gain of 31.49%, its best showing since 2013 when the index rose 32.39%. One needs to go back to the great bull market of the 1990s to find higher annual returns. Other asset classes also performed well last year. With interest rates falling dramatically, bonds turned in a very good year, with the Barclays US Aggregate Bond Index rising almost 9% and high yield bonds enjoying double-digit returns. Even gold went up 18%. For a closer look at how various asset classes performed in recent periods, please refer to the table below.

Index	Dec 2019	4th Qtr. Perfomance	1 Year Performance	Description (what the index is comprised of)
S&P 500	3.02%	9.07%	31.49%	Large cap stocks
DJ Industrial Average	1.87%	6.67%	25.34%	Large cap stocks
NASDAQ Composite	3.63%	12.47%	36.69%	Large & mid cap tech stocks
Russell 1000 Growth	3.02%	10.62%	36.39%	Large cap growth stocks
Russell 1000 Value	2.75%	7.41%	26.54%	Large cap value stocks
Russell 2000 Growth	2.29%	11.39%	28.48%	Small cap growth stocks
Russell 2000 Value	3.50%	8.49%	22.39%	Small cap value stocks
MSCI EAFE	3.25%	8.17%	22.01%	International stocks
MSCI EM	7.46%	11.84%	18.42%	Emerging markets stocks
Credit Suisse HY	2.12%	2.63%	14.00%	High Yield Bonds
Barclays US Aggregate Bond Index	-0.07%	0.18%	8.72%	Primarily U.S. Government Bonds

There were several factors helping to boost returns this past year. Chief among these was the Federal Reserve reversing course on monetary policy. In 2018, the Fed increased its benchmark interest rate four times and signaled its intent to continue to raise rates into 2019 when it met that December. Instead, it ended up easing rates three times and the official tone became much more dovish and supportive of financial markets. All else being equal, lower interest rates in general will lead investors to pour money into stocks in search of higher returns, as the yields on safer haven types of investments decline. Further, much of last year's market run-up went into erasing the steep losses investors suffered in the 4th quarter of 2018. The nearly 20% decline in the market back then contributed to the first annual loss in the S&P 500 since the financial crisis, and was the impetus for the Fed reevaluating its policy approach. A surge in stocks is common in the year following a loss. For some perspective, the S&P 500 finished the year 10.87% higher than its 2018 high, which is not that much better than the benchmark's average return of 9.8% over the past 90 years.

The tech-heavy NASDAQ and growth stocks in general outperformed the broad market. As of the end of December, just five companies – Apple, Microsoft, Google, Amazon and Facebook – comprised 29.3% of the Russell 1000 Growth Index. This level of concentration set a new record, surpassing a 29.1% weighting back during the dot.com bust in May 2001. While we do not find ourselves in a major market decline like what was taking place then, many perceive narrowing stock market leadership as a sign of a vulnerable market. However, BlackRock has researched the link between a narrow market and forward equity market performance. Their analysis shows that the relationship between the share of stocks outperforming the index at any point and market returns one year out is negligible.

Most prognosticators do not expect the next 12 months to be like the last 12 months. "The double-digit returns of 2019 will be hard to repeat" is a phrase sprinkled into almost every investment outlook for global markets in 2020. The general sentiment is that investors are going to earn less, perhaps a lot less. Given that we are already in the longest economic expansion and bull market ever, finding forecasters who are uber bullish is difficult. On balance, most pundits range from those who believe economic conditions will remain mildly positive and risk assets will continue to grind higher, to those who believe the economic backdrop will become increasingly challenging. An example of the latter is Vanguard, and in its 2020 outlook, the investment company wrote "Global growth is set to slow further in 2020, weighed

down by the U.S.-China trade standoff and continued political uncertainty. Investors should expect lower economic growth and periodic bouts of volatility in the near term, given political risk, persistent threats to growth, and high asset prices."

In general, it seems that near-term recession fears have eased from what the consensus was six months ago. Back at the end of 2018 and all the way through this past summer, you could often read in the financial press various economists, CEO's, and Wall Street types saying they thought we may be in recession by the end of 2020. This chatter has eased up some, and the Federal Reserve Bank of Atlanta's GDPNow forecasting model predicts that real GDP growth in the fourth quarter was 2.3%. Most mainstream forecasters are making relatively safe predictions for US growth in 2020 to be in the 1-2% range, and for global growth to be around 3%. In other words, avoiding a recession in the technical sense but growing below trend. In a recent interview, economist Burton Malkiel (author of A Random Walk Down Wall Street) predicted that if the economy does fall into recession this year, it would be because of an unforeseen international shock.

Malkiel made this comment prior to the recent attack on the American embassy in Baghdad by purported pro-Iranian forces, and before the American retaliatory attack that killed a prominent Iranian general. Would the US risk going to war with Iran? Given the size of the country and its population, war with Iran would be a much different state of affairs than wars in Afghanistan or Iraq, military excursions where success has been hard to measure. Based on all the saber rattling on both sides over the years, US military action would not necessarily fall into the category of "unforeseen international shock," but serious military action beyond a few drone strikes would likely have negative implications for the financial markets and global economy, especially if the price of oil were to rise dramatically.

After such a good year in the markets, there is often the temptation for investors to keep piling into stocks for fear of missing out. We agree that returns will likely be modest when compared to last year, and with asset prices so high, it may be prudent for investors to take some risk off the table, especially if you are somebody nearing retirement age. At the very least, we would recommend rebalancing portfolios, trimming the gains in positions that have done well and reinvesting those into positions that did not do so well. If you do not have bonds in your portfolio, you may consider adding some. While they are not necessarily attractive given the low level of interest rates, they do provide some diversification and a measure of defensive ballast to an otherwise stock heavy portfolio.

If you have a general administrative question about your account, please contact our customer service at 800-535-4253 option 1. If you need investment advice, please contact your firm's designated consultant or me. You can reach me at extension 1178 (510-740-4178) or at john.w@wespac.net. John Williams, Manager of Advisory Services – WESPAC