Investment Commentary

January 7, 2020

4th Quarter Recap

The U.S stock market closed out the year with a gain of 28.88%. This gain erased the 20% move down in the 4th quarter of 2018 and then some with a gain of 8.53% in the 4th quarter. All asset classes performed well in 2019.

International stocks performed well although they continue to underperform the U.S. market. The overall return for a Total International Index fund for 2019 was 21.84%.

The yield of the 10 year U.S Treasury Note at the beginning of 2019 was 2.68%. It ended the year at 1.91%. This was in line with the reduction in the Fed Funds rate of .75% in 2019.

From an investment standpoint this was one of the best years over the past decade. The consensus view at the beginning of the year was the bull market would be upended by the U.S.-China trade fight and slowing global growth.

The Current Economic and Investment Environment

The U.S economy slowed in 2019 as compared to 2018 but is still strong. Consumer spending surged buoyed by a strong labor market, wage growth and a strong stock market. The domestic economic expansion continues into its 11th straight year, the longest in U.S. history.

Overall global growth continues to slow due to trade tensions and an increasing number of geopolitical concerns.

Over the next year there are five things that could upend the U.S. economic expansion:

- Consumer Spending – A pullback in consumer spending would likely cause a slowdown in the economy. Consumers probably will not retrench on their own but any of the four remaining items below could create a pullback.
- Stock Market Reversal – With the economy performing well and interest rates remaining low, it does not seem likely stocks will experience

significant down moves. However, stocks and bonds are both overvalued and any number of unforeseen events can result in a significant sell-off.

- Debt Crisis – U.S. corporate debt has risen to more than $10 trillion, or 46% of GDP. And more than half of corporate bonds are rated BBB which is one notch above junk status. A slowdown in the economy can result in a downgrade of many of these BBB bonds. That would set off a debt crisis exacerbated by the lack of liquidity for this asset class.
- Trade Wars – The recent phase-one trade deal is not the end of trade tensions, it's merely a pause. And there is now a threat of new tariffs on European auto exports and 100% duties on some French consumer products.
- Unforeseen Events – There are any number of "unknown unknowns" that could flair up. The backdrop of current events include the rise of populist and nationalist movements across the globe, the breakdown of the post-World War II global order, strained relationships with long-term allies and protest movements in various counties.

Economists Got the Last Decade All Wrong
In the fall of 2009, the global financial crisis had just ended and economists were predicting a recovery like previous recoveries and an increase in interest rates closer to the historical average. Ten years on it is clear how incredibly wrong they were.

The economy has grown, but very slowly and interest rates remain very low. The current economic expansion is the longest on record with unemployment falling to a 50 year low. At this point, it is hard to see what will derail the current economic expansion.

Economists are still trying to figure out where their predictions went wrong. Various theories have been formulated but it could take the next decade to determine what really happened.

The New Decade
As usual there are many predictions about what the up and coming decade will bring. Most predictions are wrong and I prefer to consider "scenarios" of the possibilities. Here are some thoughts about the new decade:

- The term "techceleration" refers to accelerated growth rates led by technology. Over the next 10 years we will see even more rapid changes than in the past.

- It appears globalization has peaked. Countries will start pulling back from the rest of the world and governments will be forced to take more care of themselves. This means limits on the movement of free capital, goods, money, services and knowledge.
- The trade war with China is not about trade. It is ultimately about the race for technological superiority. We could see two different internet protocols, the U.S and China. And counties will be forced to choose one or the other rather than build out two infrastructures.
- China is building infrastructure all over the world which includes ports, railroads, pipes and telecom infrastructure. The "New Silk Road" already surrounds 63 countries, about one third of global gross domestic product.
- With interest rates near zero in most of the world, and no inflation, the old central bank models are being challenged. Monetary-policy tools no longer appear to be effective.
- During the decade there will be more grandparents than grandchildren, more people over 65 than under 5. The financial system will see massive challenges and the job market will have to adjust.
- Generation Z (born after the year 2000) will be a force for massive change. They're already 20% of the world population. This year they will be turning 18 and 19 and integrating into the real economy. They are into sustainability and services rather than goods. They're the force behind "peak cars" and an eventual 50% drop in driver's licenses.
- The use of smart devices will increase dramatically. And these devices will help unlock a massive amount of data through Big Data analytics, artificial intelligence, machine learning and smart algorithms.

All of these changes will have an impact on how we invest and what we invest in.

Review of Asset Classes

Domestic Stocks

Barring any unforeseen event, the U.S. stock market will likely continue to grind higher, although not at the same level as 2019. Large cap stocks continue to outperform small and mid-cap stocks and the growth style continues to outperform the value style.

The value style outperformed the growth style for a period of time during the 4th quarter of 2019. But that outperformance has now fizzled out and growth stocks have again regained the lead. There has been much discussion about this but there are no good answers on why value stocks continue to underperform and when that will change.

Developed International Stocks
European economic growth continues to slow. The backdrop of Brexit, trade tensions with the U.S. and political turmoil are having an effect. For 2020 it is unlikely European stock markets will outperform the U.S.

In Japan business investment and exports have weakened due to the U.S/China trade war. And a sales tax increase went into effect in October which will likely dampen consumer spending. Growth prospects for Japan are not promising for the foreseeable future.

Emerging Markets
Emerging markets became popular in the early 1990s. The idea was the potential upside growth as those economies began to develop. And yes, over time that has happened as they began making more things, delivering more services and consuming and spending more. But investment returns have been lackluster as compared to U.S stocks or developed market stocks.

In spite of the fact that emerging economies have grown, corporate profits have not made their way to shareholders. They have been squandered on profitless corporate expansions or placed into government officials' pockets or siphoned off to a CEO's friends and family.

Many market prognosticators are calling for increased investment in emerging markets in 2020 due to their valuation and economic growth (as compared with the developed foreign markets). But due to an increased level of uncertainly and risk in the financial markets, investors should be skeptical.

Bonds
In 2019 the fall in interest rates resulted in good returns for investment grade bonds. For 2020, barring any action by the Fed, interest rates are likely to remain in a narrow range. The overall return for investment grade bond funds may be close to 2.0%.

Investment returns for bonds further down the credit quality scale will be a bit higher, closer to 3.0%. The level of risk is increasing for lower rated investment grade corporate bonds but they should perform well as long as there is no downturn in the economy.

Recent Tax Legislation
On December 20, 2019, the SECURE Act was signed into law. This legislation makes significant changes to retirement accounts. These changes include the following:

- For anyone who had not reached age 70 ½ by December 31, 2019, the age for required minimum distributions (RMD) has been changed to 72.
- Qualified charitable distributions made directly from an IRA continue to be available at age 70 ½.
- Inherited IRAs are required to distribute all funds within 10 years for non-spouse beneficiaries.
- The age 70 ½ age limit for IRA contributions has been ended.
- Although not part of the SECURE Act, the life expectancy tables determining annual RMD have been changed so the amounts are lightly lower.

These changes will have a significant impact on retirement planning.