4th Quarter & 2019 Year End Review

Executive Summary

- U.S. and global stocks enjoyed a strong 4th quarter, capping off a very good year. The S&P 500 Index led the way in 2019, increasing 28.9% despite seeing no growth in composite earnings. Bonds also enjoyed gains. Balanced, diversified portfolios performed well.
- 2019's performance of stocks and bonds contrasted starkly with their struggles of 2018.
- Stock market fears of a U.S. recession and trade war-induced economic disruption proved to be unjustly magnified.
- Bond yields plunged globally in response to softening economic conditions and central bank easing. In September, a record $16 trillion in global sovereign debt traded at negative yields.
- Despite a much more upbeat outlook at year's end, many of the same economic and geopolitical issues remain and could lead to periodic uncertainty and volatility.
- VWG is positive on the investment prospects for many managers and strategies to whom we deploy capital. We advocate balance and diversification. The U.S. economy is solid, and consumer demand remains strong. Monetary policy is accommodative, and inflation is well contained.

Review of the Markets

2019's U.S. stock market performance was a textbook demonstration of two key investing concepts:

- "when everyone believes something is risky, their unwillingness to buy usually reduces the price to the point where it's not risky." *(Howard Marks)*
- "markets climb a wall of worry." *(popular)*

The 4th quarter of 2018's sharp decline left stocks at very attractive levels to start the year, making them counterintuitively less risky. And despite a fairly quick rebound in the 1st quarter of 2019, the market advanced higher the rest of the year, in direct opposition to a myriad of concerns. These included the U.S. / China trade war, the possibility of a U.S. recession, an inverted U.S. Treasury bill yield curve, a record amount of global debt trading at negative yields, and an extremely volatile U.S. policy and political environment.

Adding to this puzzle, there was no growth in S&P 500 composite corporate earnings in 2019. Increased multiples drove all of the price gains. For the year the S&P 500 Index, the common measure for large U.S. stocks, gained 28.9%. In the strong 4th quarter it rose in 11 of 12 full trading weeks, increasing 8.5%. This sharply contrasted with December 2018, when the market fell in 11 out of 14 consecutive trading days, plunging 16.7%. U.S. small stocks (Russell 2000 Index) increased 23.7% for the year. And they actually outpaced larger stocks in the 4th quarter, rising 9.5%.

Just as remarkable was the extremely low record levels of price volatility that accompanied all of the macroeconomic and geopolitical noise. As shown in the following chart, the S&P 500 Index recorded the 5th highest percentage of positive trading days in its history.

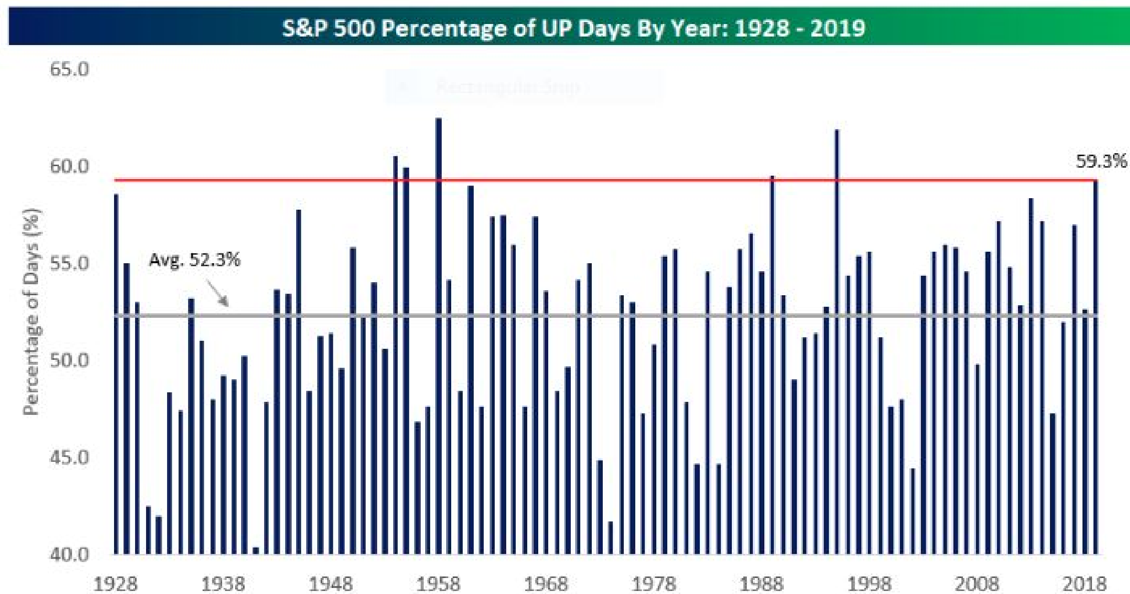

Chart and data courtesy of Bespoke Investment Group

International stocks joined the "risk-on" party, despite signs of a slowing global economy. Global manufacturing PMIs skirted contraction, setting off fears of recession. The benchmark MSCI EAFE Index increased 7.8% in the 4th quarter, and gained 18.4% for the year. Equities of emerging markets, presumed to be severely pressured by trade wars, also climbed the "wall of worry." The MSCI Emerging Markets Index came on strong in the 4th quarter, rising 11.4%. For the year it was up 15.4%.

Despite equities' persistence, bonds were the greater surprise this year. Retrospectively, it appears that the fear observed in equities at the end of 2018 was not shared by bonds. That fear emerged in 2019. Global bond yields fell steadily, pressured by the constant flow of trade policies and further threats, falling global manufacturing PMIs, and dovish central bank actions. By the 3rd quarter, a record $16 trillion in global sovereign debt was trading at negative yields. U.S. bond yields were not immune. The yield of the10-year U.S. Treasury note which began the year at 2.68%, fell to a sickly low of 1.46% in early September. It ended 2019 yielding 1.92%. The Barclays Aggregate Bond Index rose in kind, earning a total return of 8.5% for the year. It slipped -0.1% for the last quarter. High Yield bonds also performed well. The Barclays High Yield Very Liquid Index of high yield bonds gained 2.8% in the quarter and 14.9% for the year. The S&P National Municipal Bond Index returned 0.6% in the quarter, and earned 7.1% for the year.

Gold was the best performing commodity, benefiting from extremely low interest rates and periodic macroeconomic fears. The NYMEX Gold continuous futures contract increased 3.4% in the quarter, and gained 18.9% for the full year. The NYMEX West Texas Intermediate Crude continuous futures contract rebounded 34.5% after a crushing 38% loss in the 4th quarter of 2018. Reflecting global growth concerns, copper struggled for most of the year. However, the NYMEX High Grade Copper continuous contract did make a strong move in the 4th quarter, rising 6.4%. Some observers took this as a sign of optimism for better conditions in 2020.

Dubious Value in Annual Predictions of Market Performance

After a strong year of equity and bond market performance, that followed 2018's weak year for both, what should investors expect for 2020? VWG Wealth Management has often cautioned of the "fallacy of expert prediction," as researched by Philip Tetlock. As such, we pay little attention to the bountiful prognostications for the performance of next year's stock and bond markets.
Bespoke Investment Group confirms the dubious value of these predictions. "Every year we see a similar trend where just about every (U.S. stock market) target is positive and in the mid-single-digit percentage range. The fact that strategists are predicting a positive return in the mid-single-digit range for 2020 is no coincidence, as it also falls in line with long-term historical returns."
Surprisingly, Bespoke's research shows that the occurrence of the market's long-term annual return in any single year is relatively uncommon. The following histogram shows the returns for the Dow Jones Industrial Average for the past 120 years. In only 21 of these (17.5%) did it earn a positive return less than 10%.

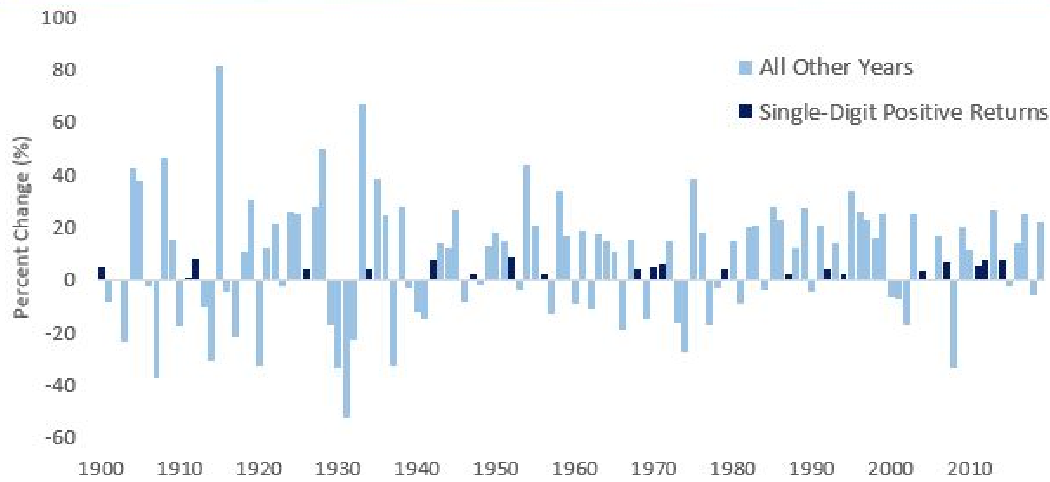

Chart and data courtesy of Bespoke Investment Group

This is just another demonstration that we need to have balance and patience in order to handle stocks' year-to-year up-and-down surprises. The fruits of stocks' long-term returns will be greatly soured if we become overly influenced by periodic disappointment, or exuberance. VWG advocates defining a target allocation to stocks, and then diversifying portfolios beyond traditional stocks and bonds. We attempt to buffer our clients from the behavioral perils of annual and periodic undulations.

Insights from the Experts

Beyond our disdain for annual market predictions, VWG regularly scours the deeper thinking of strategists and money managers we greatly respect. We actually seek out and embrace a group of divergent opinions, finding comfort in our belief that no one could possibly have the full set of keys to this complex, dynamic puzzle of economics, geopolitics, investing and psychology. Despite today's much fairer climate, the forward forecast for 2020 is no more certain than it was a year ago. Here are some recent notable points:

Rick Rieder, Chief Investment Officer of Global Fixed Income, BlackRock – *"The real (U.S.) economy is very stable. Recession and economic calamity fears are most likely exaggerated. Central banks have to manage to the lowest common denominator, and the European Central Bank has some very sick children to tend to. If corporate profit margins can be maintained, 1-2 more turns of multiple valuation can be realized in U.S. stocks in 2020 without any earnings growth."*

Michael Darda, Chief Economist & Chief Market Strategist, MKM Partners – *"We are tactically cautious, and we advocate diversification. We are seeing some signs of excessive (stock) market optimism. The U.S. economy is slowing. One cannot overlook that the yield curve was inverted for 4 months in 2019, which is historically predictive of a recession 12-months forward."*

Tony Crescenzi, Market Strategist, PIMCO – *"Bond investors should expect the coupon only in 2020. They should stay liquid, resilient and agile. The risks to bond holders are largely one-sided, the bond market is priced to perfection, so be careful. This doesn't mean that investors should try to market time the diversification benefits of high-quality bonds."*

Tim Hayes, Chief Investment Strategist, Ned Davis Research – *"We would be more positive if (stock market) breadth improved. Globally the top 10 stocks account for 12% of market capitalization, which is about as high as it has been since 2000. With sentiment stretched and breadth not confirming, we're tactically cautious."*

Laslo Birinyi, Founder, Birinyi Associates – *"We disagree with the contention that one should review your circumstances and objectives at year's end. You should do so at critical junctures. We continue to favor stocks, look for higher prices and maintain our core holdings. Our main concern is sentiment. We are somewhat uncomfortable that the market is apparently discounting or glossing over some concerns, including geopolitical tensions, and mixed economic data."*

Tony Dwyer, Chief Market Strategist, Cannacord Genuity - *"The (U.S. stock market) is not at an extreme valuation at 19x trailing 12-month earnings-per-share. This is an historically average multiple in periods when core inflation is between 1-3%. We see a positive inflection in global activity from very weak levels, that should only be helped by the Phase 1 trade agreement between the U.S. and China."*

Chris Verrone, Head of Technical Analysis, Strategas Research Partners - *"Almost 80% of stocks in the S&P 500 are trading above their 200-day moving average. This is the best reading in several years. Overbought markets are reflective of positive momentum and a desired feature of good trends. Pullbacks are buyable should a Q1 correction unfold. The composition of 2019 equity fund flows is remarkable – industrial, financial and energy ETFs all saw outflows while the money went into defensive sectors. Better times are ahead for European equities. Chinese equity charts are improving."*

Paul Krake, Founder, View from the Peak – *"We have seen a decade of the most extraordinary monetary expansion and policy prescription the world has ever witnessed, yet structural growth rates have fallen everywhere across the globe. Excessive credit availability as a driver of demand should be discounted. However, its continual effect on the value of capital should not. Global growth will remain soft in 2020. US growth will slip below trend as fiscal stimulus wanes and capital expenditures are weak due to election uncertainty. Chinese growth has been slowing for a decade and will continue on this path. This all ensures that the Federal Reserve will not raise rates, and will most likely ease in 2020. Bond yields are capped, therefore the attractiveness of equities versus fixed income remains quite stark."*

Portfolio Strategy and Asset Positioning

VWG Wealth Management is positive on the U.S. economy, and on the investment prospects for many managers and strategies to whom we deploy capital. Liquidity and monetary policy are accommodative. U.S. consumer demand and the housing market is solid. We believe a balanced, diversified portfolio is called for. It should include non-traditional stock and bond assets, and an allocation to short-duration quality bonds.

We will not be surprised by more typical, periodic outbreaks of volatility and uncertainty. Despite today's rosier market sentiment, most of the big picture macroeconomic and geopolitical issues that plagued markets in 2018 have not changed. S&P 500 corporate earnings are going to have to resume some growth in 2020. The world economy is still starved for growth with no visible remedy, despite ever-rising levels of private and public debt. The rise of populism and provincialism, outbreaks of trade and currency skirmishes, the predominance of negatively-yielding global bonds, and surging global private and public debt balances, are all endemic of this. In a slow growth environment, market reactions to any small wobbles or aberrations will become magnified. The U.S. presidential election could further complicate this mix.

Within equities, VWG will be looking for opportunities to move a portion of U.S. stocks into international stocks. In the decade ending in 2019, the S&P 500 total return index has gained 252% versus just 61% for the rest of the world (MSCI All-World ex-US total return index). In the previous decade the S&P 500 fell 9% while the rest of the world gained 31%. Although these patterns should not be expected to follow rigid 10-year sequences, this is a reminder that US stock dominance cannot persist forever. From a mean-reversion standpoint alone, it makes sense to shift a portion of equity allocations to proven international equity managers.

Best wishes to everyone for a prosperous and healthy 2020!

It is a great honor to hold the trust you have placed in us. VWG's foremost goal is to protect your capital and help you achieve your long-term financial objectives. To fulfill this, we remain vigilant of future perils and opportunities. Furthermore, we are planning a number of exciting new team and service enhancements to further strengthen our efforts. We look forward to sharing these with you soon!

Regards,

VWG Wealth Management

Suzanne, Ashley, Rashmi, Kay, Lynette, Michelle, Ryan, Susan, Marnie, Justin, Elana, Patricia, John, Rick and Jeff

Who we are

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VWG Wealth Management

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