Mount Yale Market Commentary

4th Quarter 2019

Summary

- Scattered economic improvement, better data, and supportive central banks combined to boost returns across asset classes around the world.
- The Federal Reserve deployed several monetary policies that were initially intended to mitigate financial crises, though today's economic environment remains benign.
- The Fed's actions were not limited to interest rate cuts and also included extraordinary steps such as the resumption of quantitative easing in support of the repo market and public comments regarding a tolerance for higher future inflation.
- The closely watched U.S. presidential election will likely only be seen as disruptive by market participants if Elizabeth Warren or Bernie Sanders is elected.

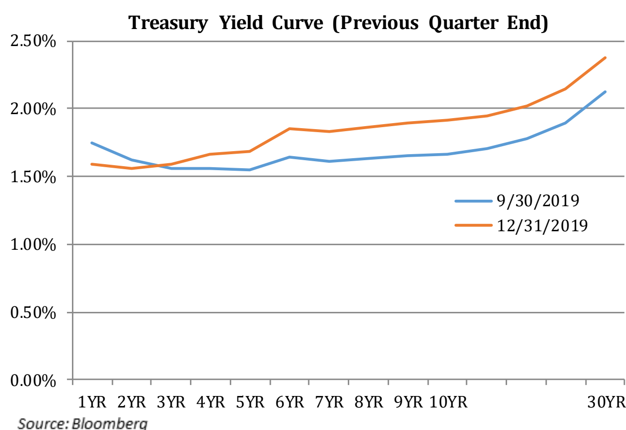
Global Markets	*QTD*	*YTD*
MSCI ACWI	8.95%	26.60%
Barclays Global Aggregate	0.49%	6.84%

Source: Bloomberg

Overview

In keeping with the rest of 2019, global capital markets produced strong gains during the fourth quarter—and incredibly impressive returns for the year as a whole. Scattered economic improvement and better data drove some of these results. A more important factor, however, was significantly more support from central banks, in particular the Federal Reserve.

To make good on its earlier promises, the Fed implemented several extraordinary accommodative policy measures during the past quarter. This included cutting 25 basis points from the fed funds rate in both September and October, and—in efforts to support the repo market—a restart of the quantitative easing program that will have the Fed purchasing U.S. Treasury Bills through the second quarter of 2020, at least. This dramatically reversed the quantitative tightening policy that the Fed put in place in the fourth quarter of 2018, which was intended to reduce the Fed's balance sheet. Since its return to quantitative easing late last year, the Fed has already expanded its balance sheet by approximately $400 billion.



The Fed's policy goal has always been to foster economic conditions that achieve both stable prices and maximum sustainable employment. Generally, the Fed strives to keep inflation at about 2%. However, Fed Chairman Jerome Powell's comments late in the year made it much more challenging to evaluate the 2% inflation objective:

> *"In order to move rates up, I would want to see inflation that's persistent and that's significant. A significant move up in inflation that's also persistent before raising rates to address inflation concerns: That's my view."*

During the quarter, the Fed also began providing additional support to the stressed repo market in the form of billions of dollars every day. This loosening comes at a time when financial conditions (as measured by the Chicago Fed National Financial Conditions Index) have not shown any material signs of tightening whatsoever, remaining at cycle lows.

All this extraordinary support comes during what appears to be quite ordinary times in the economy and in capital markets. For instance, economic growth is muddling along in the 2-3% range, similar to previous years and certainly not close to recessionary territory; unemployment is extremely low at 3.5%—the lowest since the 1960s; inflation is moderate as measured by a CPI of 2.0%; and equities are at all-time highs while credit spreads remain near cycle lows.

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Like the popular energy drink that combines sugar and caffeine, benign growth and abundant liquidity were a Monster cocktail for asset prices. Represented by the S&P 500, U.S. stocks were higher by 9% for the quarter. For the year, they finished up 32% (the second-best return since the tech bubble of the late 1990s). Many other asset classes performed extraordinarily well in 2019: Investment-grade taxable bonds were up nearly 9% (best return since 2002), and gold was higher by 18%.

Despite their long-term correlation to equity returns, corporate earnings took a back seat in 2019. At the beginning of the year, analysts anticipated 9% earnings growth for the S&P 500. However, if fourth quarter 2019 estimates are accurate, earnings for S&P 500 companies grew by a meagre 4% in 2019. Therefore, the S&P 500's massive 32% gain for the year came mostly from multiple expansion (i.e., investors paying more for the same amount of corporate earnings). To put this in context, the trailing 12-month price-to-earnings multiple increased by 3.9x (or 24%) to end the year at 20.4x. The last time the S&P 500 experienced that much multiple expansion during a bull market was during the tech bubble in 1998. That year, the S&P 500 rose 27% on a miniscule 0.6% year-over-year earnings growth!

US Equity Markets	*QTD*	*YTD*
S&P 500	9.06%	31.48%
Russell 1000 Growth	10.62%	36.39%
Russell 1000 Value	7.39%	26.52%
Russell 2000	9.93%	25.49%
MSCI US REIT	(1.10%)	24.33%
Alerian MLP	(4.17%)	6.29%

Source: Bloomberg

The strong equity performance generated within the realm of lackluster fundamentals is a stark reminder of the link between interest rates and riskier assets. Interest rates (and bond yields) act as both the discount rate and low risk alternative to riskier assets. Low interest rates—especially those below the rate of inflation—are a monstrous incentive to take risk.

U.S. Markets

Large cap and small cap stocks performed relatively the same while growth stocks outperformed value yet again. The Russell 2000 Growth Index gained 11.4% for the quarter while larger companies, as measured by the Russell 1000 Growth Index, gained 10.6%. The Russell 2000 Value Index increased by 8.5% while the Russell 1000 Value Index rose by 7.4%. Large cap growth stocks were up 36.4%, and small cap growth stocks were up 28.5% for the year. By comparison, large cap value was up 26.5%, and small cap value was up 22.4%.

S&P GICS Sectors	*QTD*	*YTD*
Consumer Staples	3.51%	27.61%
Health Care	14.37%	20.82%
Utilities	0.80%	26.40%
Communication Services	8.99%	32.69%
Consumer Discretionary	4.47%	27.94%
Energy	5.49%	11.81%
Financials	10.44%	32.09%
Industrials	5.50%	29.32%
Materials	6.37%	24.58%
Real Estate	(0.54%)	29.00%
Technology	14.40%	50.29%

Source: Bloomberg

The technology sector capped off its phenomenal year, up 50%, with an equally phenomenal quarter, up 14%. Healthcare was also up 14% for the quarter, which accounted for the majority of its 21% return in 2019. Laggards for the quarter included real estate and utilities (which are sensitive to interest rate movement), down 0.5% and up 0.8%, respectively. Even with their tepid fourth-quarter returns, both sectors had big years. Real estate was up 29%, and utilities was up 26%. Energy—by far the worst-performing sector—was up just 12% in 2019.

Another boost to equity returns has been companies' immense stock buyback programs. These programs help increase returns in two ways: first, the increased amount of stock purchases helps returns; second, the fact that there are fewer outstanding shares increases a company's earnings-per-share without the company actually having to improve its earnings.

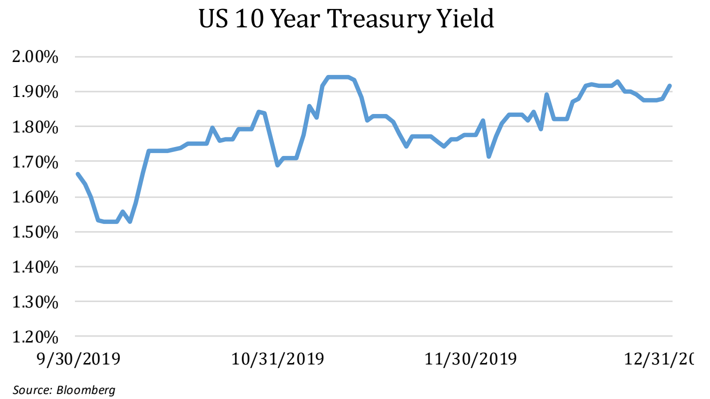
During the first half of 2019, the rate of stock buybacks increased materially, but in the third quarter, they declined by 14% on a year-over-year basis. One explanation for this slowdown could be that tepid corporate earnings sapped companies' ability to institute new buyback programs. If that's the case and corporate management teams are shying away from buybacks as earnings slow, then buybacks could continue to decline throughout 2020. If that does in fact occur, a major lift to equity returns would be stripped away.

US Fixed Income Markets	*QTD*	*YTD*
Barclays US High Yield	2.61%	14.32%
S&P/LSTA Leveraged Loan	1.73%	8.64%
Barclays US Aggregate	0.18%	8.72%
Barclays Municipal High Yield	0.90%	10.68%
Barclays Municipal	0.74%	7.54%

Source: Bloomberg

In fixed income markets, as part of the fourth quarter's unwavering risk-seeking tendencies, lower quality fixed income securities outperformed their investment

-grade counterparts. The Bloomberg BarCap High Yield Corporate Index increased by 2.6%, which moved it to up 14.3% for the year. The Bloomberg BarCap U.S. Aggregate Bond Index was up a paltry 0.2% in the quarter, leaving it up 8.7% in 2019. Municipal bonds, as measured by the S&P National Municipal Bond Index, gained 0.9%, leaving them up 5.6% for the year.



One slight performance divergence emerged in 2019 that bears watching. Unlike high yield bonds, the S&P/LTSA Leveraged Loan Index did not make a new high during the year, despite posting a solid 8.6% return. As 2019 progressed, the index's constituents experienced an increasing number of credit downgrades relative to upgrades—a potentially ominous signpost on the health of the U.S. credit markets. By year end, downgrades were three times higher than upgrades—the widest gap since 2009.

Foreign Markets

Non-U.S. markets, both developed and emerging, enjoyed positive, broad-based returns for the quarter. Just one country, Chile, posted decidedly negative returns. Global trade tensions de-escalated during the quarter, thanks in part to the U.S. and China agreeing on an enforceable, phase one deal that focuses on intellectual property, technology transfer, agriculture, financial services, and currency and foreign exchange. This development cleared the way for emerging market assets to generate the majority of their 2019 return in the final quarter of the year. In dollar terms, the MSCI Emerging Markets Index rose by 11.9% in the quarter, bringing it to 18.9% for the year. China gained 15% in the quarter and was higher by 24% in 2019. Russia and Greece generated the best returns outside the U.S. in 2019; both increased approximately 50% in dollar terms. In local currency terms, the MSCI Emerging Markets Index gained 9.6% during the quarter and 18.5% in 2019.

Foreign Markets	*QTD*	*YTD*
MSCI EAFE	8.23%	22.77%
MSCI EAFE Small Cap	11.56%	25.47%
MSCI EM	11.74%	18.63%
MSCI EM Small Cap	9.40%	11.61%
S&P Global Ex-US REIT	4.44%	23.59%
JPM EMBI Global Diversified	(25.42%)	(33.08%)
S&P/Citigroup Int'l Trsy Ex-US	0.04%	4.56%

Source: Bloomberg

Developed markets outside the U.S., as measured by the MSCI EAFE Index, rose by 8.2% in dollar terms. For the year, the index was higher by 22.7%. One cloud that was lifted during the quarter was in the United Kingdom. Conservatives won a majority in the December elections, and Prime Minister Boris Johnson declared that the UK would leave the European Union in early 2020. As a result, UK equities increased 10% in the quarter and ended the year up 21%. In local currency terms, the MSCI EAFE Index was higher by 5.2% during the quarter and 22.3% for the year.

In some of her first formal remarks as the new head of the European Central Bank (ECB), Christine Lagarde had some interesting comments regarding monetary policy and its effects on climate control. In December at the United Nations Climate Change Conference COP25 in Madrid, Lagarde called the fight against climate change "mission critical" for the ECB. Lagarde committed to focusing more on green assets (green bonds for example) and to potentially unwinding those ECB assets that have a high carbon footprint.

> *"The primary mandate is price stability. But it has to be embedded that climate change and environmental risk are mission critical."*

Currently, the ECB spends about $20 billion per month on a bond-buying program that seeks to address lackluster inflation.

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Looking Ahead

The new year will certainly bring increased focus on the upcoming U.S. elections. Despite a volatile political environment in the U.S., the presidential election will likely only disrupt markets if either Bernie Sanders or Elizabeth Warren wins, primarily due to their views on corporate taxes.

According to most recent data from betting site PredictIt, neither of these candidates appear to be in a position to make a meaningful run at the White House. Current odds for each candidate are as follows: President Trump at 51%; Biden at 20%; Sanders at 6%; Warren and Bloomberg tied at 4%. These numbers will certainly change—and their significance will increase—in the coming months and into Super Tuesday, after which forecasts will become more accurate.

Sincerely,

Mount Yale Research Team

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