Review & *Outlook*

FOURTH QUARTER 2019

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Review and Outlook

The U.S. stock market finished a strong fourth quarter, and the major indexes, including the CRSP and S&P 500, end the year up roughly 30 percent. That return is the best we've seen in decades, and a welcome rebound following the negative returns we saw in 2018.

Unfortunately, many people moved out of stocks in late 2018 due to declining prices and talk of a pending recession. When the market reversed course sharply in early 2019 and started to increase, many investors stayed in cash, lacking confidence in the market. Investors also took cash out of the market in the middle of the year when the trade war seemed to be taking a turn for the worse and the yield curve inverted. All told, investors pulled $130 billion out of U.S. stock mutual funds and ETFs through the first ten months of the year, putting much of that money into bonds and mutual funds. We held a small amount of cash and a small position in defensive securities during much of the year as a hedge against a possible (pre-recession) market downturn, but remained almost fully invested, favoring U.S. equities. In early 2019, we invested some of what we normally hold in stocks into longer dated bond funds. As the Federal Reserve lowered rates during the year, those funds increased in value. Then late in the year we rebalanced to move those funds back into stocks.

Index Performance Data
Total Return as of 12/31/2019

Indices[1]	Q4 2019	Trailing 12 Months
CRSP U.S. Total Stock Market Index	9.00	30.84
MSCI Global ex-U.S. Total Stock Market Index	8.52	18.12
Bloomberg Barclays U.S. Aggregate Bond Index	0.18	8.72

We have been "underweight" in global stocks for the past two years. In fact, we did not hold any global stocks at the end of 2018. We waited until the middle of January 2019 to reinvest in that asset class, which meant we missed a portion of the return in that area for 2019, but did well relative to our benchmark for the rest of the year. We will remain underweight in global stocks until we see policy decisions in Germany, China, and other countries that imply stronger growth. And we want to see how Brexit unfolds before investing more heavily in global stocks.

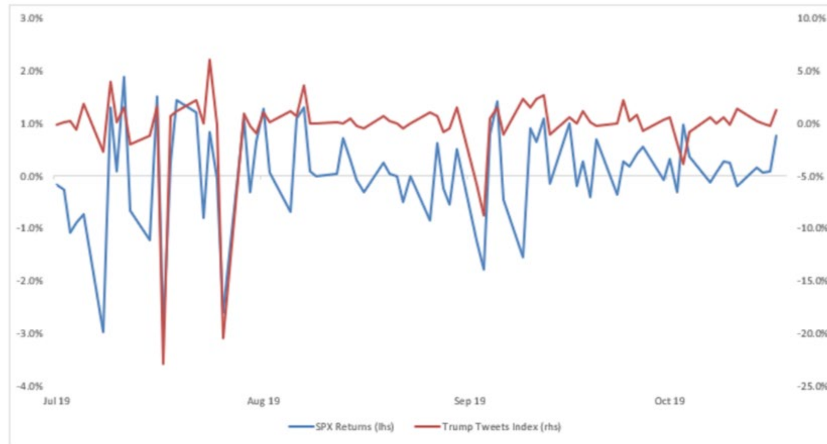
We also continue to avoid the energy sector, including the Master Limited Partnerships we once held in our 'alternatives' asset class. The combination of slowing global demand for oil and concerns about the debt held by many oil companies (especially those developing shale reserves) make us skeptical about that sector.

As we head into 2020, we get to wonder about tensions with Iran and other events of the day. The stock market is often volatile the summer before a presidential election, and we imagine that volatility might start earlier this year. Some pundits argue a Sanders or Warren presidency will "roil the markets." We know a wealth tax and significant change to how we fund health care in the U.S. would be disruptive, but it isn't clear that the policy ideas offered now by the candidates would actually be enacted through legal and regulatory change. Major change with a divided government is unlikely, and even so, the economy and market can diverge. For example, one could reasonably argue that transferring money from billionaires to people who spend every dollar they have could be good for economic activity. However, if the billionaires have to sell assets sitting in stocks and/or bonds, it could be problematic for financial markets. Our task is to filter the noisy rhetoric to determine what might truly affect the economy and the market.

We expect the tug-of-war between the strong U.S. labor market and a weak global economy to continue into 2020. A

central question for months has been whether or for how long the U.S. consumer can carry the economy in the face of economic weakness around the world, since most leading economic indicators are going sideways at present. They aren't going down, but they aren't going up either, so we are proceeding with caution. In the near term, we are keeping an eye on initial unemployment claims; whether corporate earnings suffer from higher labor costs; and the strength of the U.S. dollar. A trending weaker dollar could mean higher interest rates, which would help banks but cause stress in specific areas.

With so much uncertainty, we expect the first part of 2020 to be more volatile than the fourth quarter of 2019, and we expect the slight upward trend to continue in the stock market as long as the labor market stays strong and provides a foundation for consumer spending.



In Focus

JP Morgan estimates that President Trump or those with access to his Twitter account have tweeted more than 10,000 times since his inauguration.[2] Regardless of the exact number, the issue for us is whether those tweets actually affect the financial markets. We've observed that the tweets do have an impact, but they mostly just add to short-term market volatility more than they move the market up or down in a meaningful way. The volatility we saw in the stock market this past summer was due in part to uncertainty about trade, and in part to the President's tweet attack aimed at Jerome Powell, chairman of the Federal Reserve. Given that the president increased his tweeting on both topics in August, it really isn't that surprising that the stock market fell 2 percent that month, then recovered (because nothing had fundamentally changed). Bank of America Merrill Lynch estimates that stocks fall on days during which Trump tweets more than 35 times per day and rise on days he tweets less than 5 times.[2] In the long run, there seems to be an equal distribution of ups and downs, leaving the stock market largely unchanged. But correlation does not imply causation, and there is no evidence to suggest what the President tweets actually drives the market.

If the President tweets something truly consequential about trade policy, it can impact the market. But our view is that it would be a fool's errand to try to anticipate such tweets or try to include presidential tweets in a management strategy. Instead, we focus on the fundamentals and larger forces, like the value of the U.S. dollar and corporate debt.

That being said, we think that the 2020 election is something large enough to consider because we need to have plans in place for different possible outcomes. But we focus on the factors that drive stock and bond prices, instead of getting distracted by political posturing and rhetoric. As with presidential tweets, we have to look past glib comments to analyze the fundamental issues that affect markets over time. There are proposals from candidates that get our attention, and we have formulated investment strategies for any number of potential outcomes. For instance, Bernie Sanders' proposal to tax stock trades at 0.5 percent and bond trades at 0.1 percent raises questions about whether such taxes would affect IRA and 401(k) accounts, and whether taxing stock trades at that level would alter investor behavior. We would certainly trade much less frequently and look for alternatives not subject to the tax, including lower-taxed overseas funds. This is just one example of how we are thinking about things going into the 2020 election cycle.

1. Index price data is downloaded from ICE Data Services. Index performance data is calculated by Axys portfolio accounting software, a product of SS&C Advent.
2. https://www.usnews.com/news/economy/articles/2019-10-08/study-trumps-tweets-move-the-investment-markets
3. https://towardsdatascience.com/covfefe-nlp-do-trumps-tweets-move-the-stock-market-42a83ab17fea

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