Monthly Perspectives - Disciplined Equity

January 2020

It is said that people love surprises, although this adage clearly didn't emerge from surveys of stock market investors. That said, this past year has proved to be the exception, having produced little but positive surprises for investors. This in the face of the widely held conviction that the days of rampant stock market advances were behind us, or at least not in our immediate future. We ended 2018 with a falling market. Even as the market recovered in the first half of 2019, the gains appeared fragile. When the yield curve inverted this past summer (short-term bonds yielding more than long-term bonds) talk of recession was rampant. Stocks ignored the warning behind a reversal in Federal Reserve (Fed) tightening and went on to make another steady move upwards through the end of the year.

All of which is to say that one result that was not predicted for 2019 was a stunning S&P 500® return of 31.5%. If you went back ten years to the fading memory of the Great Recession, the prospect of 13%-plus annualized returns over the ensuing decade would have sounded Pollyannaish. But that's exactly what we have booked, with the S&P 500 rising nearly 400% from its 2009 lows. And let's not leave bond investors out of discussion: the Barclays Aggregate Bond Index was up 8.7% for the year, a result that would have seemed unlikely given Fed policy and historically low interest rate environment in January when the 10-Year Treasury yield was hovering around 2.7%.

In the U.S. stock market, the returns were strong across the board, with growth outperforming value and large and mid-cap stocks outperforming smaller stocks. Sector returns were dispersed, but above 20% for the year for all but the low double-digit trailing Energy Sector, while the Technology Sector led the way with a 50.3% total return. Diversified portfolios were destined for solid results.

As we enter a new decade, the more pressing concern for investors is what to expect going forward and how to prepare for it. When we look back to those terrifying days on the brink of financial collapse in 2008 and 2009, we are oddly enough spanning what is the longest bull market in U.S. history. By standard measures, stock valuations are generally stretched, and the market is now more dependent on earnings growth.

Yet the market advance has been supported by better macroeconomic data led by the US consumer who has benefited from a robust job market and has followed through with 3% year-over-year growth in personal consumption expenditures. The economy is likely to benefit from global monetary stimulus implemented in the latter part of 2019 and central banks have indicated that rates will stay at these low levels for the foreseeable future. International trade policy remains unpredictable, but the Phase One deal with China eliminates certain tariffs and reduces the rate of previously announced tariffs. This should generate some growth in industrial production. Corporate spending could also resume after a lull in 2019.

Past performance does not predict future results.

Uncertainties remain in 2020 with a Presidential election, renewed geopolitical tensions in the Middle East, and increased volatility in energy and commodity prices. The outcome of the Presidential election could impact tax rates, regulations on businesses, as well as fiscal, foreign, and trade policies. We are carefully paying attention to these factors as we approach the election and are currently not making dramatic changes to the portfolio. Geopolitical tensions in the Middle East are often correlated with a spike in energy prices. High energy prices over a sustained period will negatively impact domestic and global GDP growth. The US has increased domestic energy production and is less dependent on oil imports, nonetheless the risk remains.

To sum up, the markets in 2019 benefited from aggressive global monetary stimulus and a healthy consumer even as the trade war intensified. Uncertainty seems to never disappear and 2020 is another year where the undetermined outcome of a Presidential election will have a lasting impact on the markets for the next four years. We encourage investors to be prepared for some volatility and considerably more modest stock and bond returns. These are conditions which we believe will increase risk awareness among investors, an attitude that is already incorporated in our investment philosophy and day-to-day process. Stressed markets generally inspire investors to look for companies with strong fundamentals and stability of earnings, qualities which are already criteria for the stocks held in your portfolio. A steady hand will likely be needed by all – a lesson exemplified by the trying times that began this trailing ten years of capital expansion.