COMPASS
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Points

January 21, 2020

Fourth Quarter Market Review

The Compass portfolios generated strong returns for 2019, a bullish year for nearly all financial markets. The positive broad-based returns marked a dramatic (and welcome) turnaround from 2018, a year in which nearly all asset classes faltered.

This year's surprising returns were fueled by a U-turn in monetary policy, as policymakers shifted gears to support a weakening global economy. After tightening financial conditions (raising short-term rates) four times in 2018, and the Federal Reserve's December forecast for two more rate hikes in 2020, the Fed reversed course and began implementing a more dovish monetary policy (lowering short-term rates three times). This change in course from hawkish to dovish is referred to as the "Powell Put" showing the Fed's intent on waiting to see how conditions evolve before making another move. Other major central banks also cut rates or provided additional stimulus to the markets via quantitative easing during the year, lessening global recession fears.

U.S. stocks rose in every quarter and surged an additional 9% in the fourth quarter as the United States reached a tentative "phase one" trade agreement with China. Despite the dour narratives of 2019, the S&P 500 came close to having its best year since the Tech Bubble. According to our friends at The Leuthold Group, Microsoft and Apple, a combined 9.1% of the index's market cap, punched above their enormous weights and together contributed +15% of 2019's S&P 500 return. We are glad Microsoft and Apple are in holdings in four of our Compass models.

Foreign markets were also strong. European stocks gained 9.9% in the fourth quarter and emerging-market (EM) stocks shot up nearly 12% in the fourth quarter.

The 10-year Treasury yield dropped from 2.70% at the start of the year to as low as 1.45% in September, ending the year at 1.92%. Investment-grade bonds gained nearly 1.2% in the fourth quarter. Credit markets also rallied amid this supportive monetary policy environment with high-yield bonds earning 2.6% for the quarter.

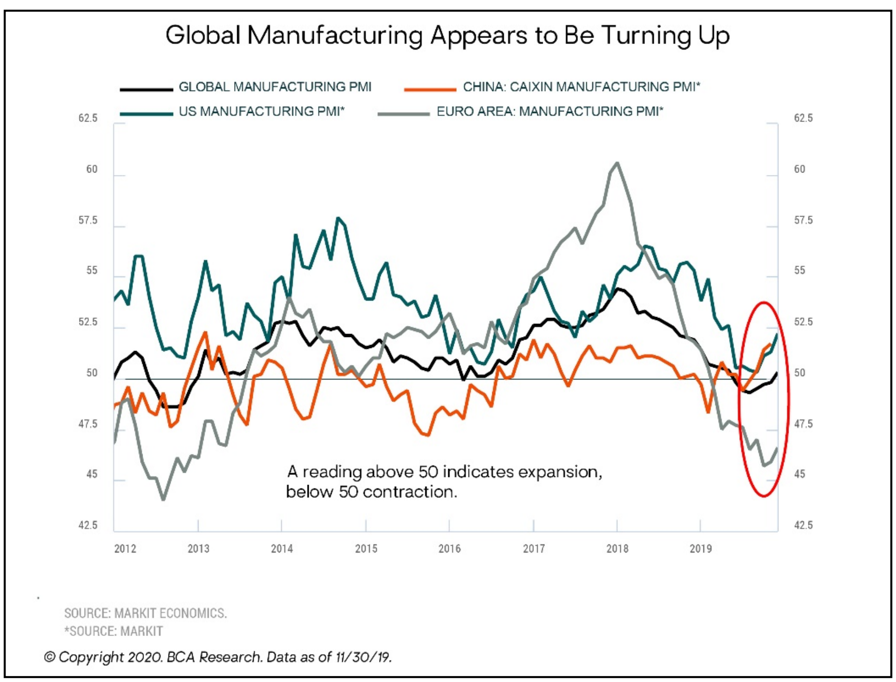
Commodities also had a good year and quarter, with Gold (London PM Fixed) gaining 2% and WTI Crude Oil up a whopping 13% for the Q4.

What's Next for 2020?

After a year like 2019, the obvious question looking ahead is how much higher can equities go? For many years, assets have been flowing into U.S. stocks on the back of a strong U.S. dollar and the United States' perceived safe-haven status relative to other global economies. In this respect, 2019 was largely an exclamation point on the decade's investment pattern.

As we look ahead to financial markets in 2020, there are reasons to be cautiously optimistic for financial markets. Accommodative central bank monetary policy and easier financial conditions should continue to support at least a modest rebound in global economic growth. As just one point of reference, the Global Manufacturing Purchasing Managers' Index (PMI) has risen for four consecutive months and inched into expansion territory (above 50) in November. Along with reduced U.S.-China trade risk, this suggests the global economy may be on the rebound. The U.S. consumer also remains in good shape as ongoing labor market strength, wage growth, and low interest rates should continue to support consumer spending and the housing market.

However, this modestly positive outlook is consistent with the consensus view, meaning that financial markets have already responded positively to these developments. The risk of an unpleasant market surprise or deterioration in the macro environment in 2020 shouldn't be ignored.



A critical question for fundamental investors is, "What's in the price?" In this regard, we note that it wasn't corporate profit growth that drove U.S. stocks higher in 2019. Reported earnings for the S&P 500 were actually flat over the first three quarters, and mid-single-digit percentage growth is projected for the fourth quarter. The lion's share (roughly two-thirds) of the S&P 500's 31% return came from a sharp expansion in valuations. We believe such stretched valuations leave U.S. stocks vulnerable to disappointment or negative surprises in the macro environment.

Despite recent positive developments, the U.S.-China trade war could reignite or a different area of geo-economic conflict between the two countries could escalate. This would hurt a still-weak manufacturing sector and impact capital spending and business confidence (CEO confidence is already at recessionary levels).

U.S. election uncertainty, inflation surprises, and Brexit are also among the myriad risks that could impact markets over the coming months. Geopolitical risk is also, as always, a major unknown that we factor into our portfolio downside stress-testing. In early January, global tensions became extremely high following the unexpected killing of Iran's military commander by U.S. forces and now Iran's retaliatory missile strike. While it is far too early to know how this will play out on a broad scale, equity markets have largely taken this in stride.

Lastly, a new possible threat has emerged. A new Coronavirus, a SARS-like disease, is infecting hundreds of people in China and Asia. Some people are starting to fear the possibility of a pandemic as this new strain can be transmitted between humans. While this is in the early stages, this should be watched closely. Recall that SARS made headlines in late 2002 and the disease spread rapidly through China and 30 other countries and territories. SARS was eventually stopped in 2003, but not before wiping out $40 billion from the global economy, including $7 billion in losses for the U.S.

Portfolio Positioning and Outlook

In 2019, the Federal Reserve pumped historic stimulus onto a full-employment economy and an already richly valued stock market. According to Doug Ramsey, Chief Investment Officer at The Leuthold Group, "the stock market obviously loved it, and the expectation is practically unanimous that the economic numbers will follow suit in the months ahead. While that has yet to happen, we're assured that monetary stimulus invariable impacts the real economy with a nine-to-twelve-month lag. With the Jay Powell 'pivot' having occurred just over a year ago, an upturn should be imminent if it's in the cards."

History tells us that it is difficult to get growth to accelerate once the economy has reached full employment, which is especially true for corporate profits. We will have to wait and see over the next few months whether the data confirms or rejects that tendency.

Should the positive global growth outlook for 2020 play out, our tactical nature would have us increase our exposure to the international markets. We would expect foreign stocks to outperform U.S. stocks, given their higher cyclicality and sensitivity to overall GDP growth. Receding Brexit uncertainty should also help prop up European markets, in particular. Furthermore, to the extent the U.S. dollar weakens in this environment—due to it being a *counter*-cyclical currency—that will help foreign stock returns (for dollar-based investors).

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These tactical opportunities are relatively attractive, but none of them are without their own risks. There are few table-pounding, valuation-based fat pitches in the investment markets these days. Ten-plus years of unprecedented central bank stimulus and interest rate repression have inflated the prices of most financial assets, if not the actual global economy.

Given this backdrop, weighing the shorter- and medium-term risks and return opportunities, and considering the economic fundamentals versus financial market valuations—we think the wisest course for balanced investors continues to be broadly diversified, tactical in nature, and moderately defensive.

We wish everyone a happy, healthy, and peaceful New Year.

We appreciate your confidence and trust!

Best Regards,

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The Compass Asset Management Team