Quarterly Investment Perspective

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Key Points:

- *Stocks around the world delivered strong returns in 2019 that more than offset 2018's losses. Similarly, bonds gained significantly due to a combination of falling interest rates and strong investor demand. The 2020 return outlook for both stocks and bonds is lower, but still positive. Stock market volatility will likely increase in 2020, and bonds will continue to be essential diversifiers in a portfolio.*
- *U.S. economic growth slowed but remained positive in 2019. Globally, growth in 2019 likely grew at its slowest rate since 2008-09. The global growth slowdown has likely neared a bottom, and the risk of a global recession has diminished. Continued central bank stimulus will likely result in a modest pickup in economic activity once again.*
- *After such a strong year for stocks with the U.S. stock market once again reaching new all-time highs, many investors are wondering whether they should stay invested. Although stock market volatility is likely to increase in 2020 as the markets face a myriad of geopolitical issues, we highlight reasons why investors should stick to their investment plan and not try to time the market.*

Market Review & Outlook

Stocks rose in 2019 on allayed global recession fears

Stocks around the world delivered strong returns in 2019 that more than offset 2018's losses. (See **Figure 1**.) Despite a global slowdown in economic and earnings growth, U.S. and international stocks, in aggregate, had their best year since 2009.[1] The sharp recovery was due to a reversion from extreme investor pessimism (in late-2018) about rising interest rates and geopolitical tensions which coincided with early signs of a global slowdown. The dramatic change in sentiment in 2019 was mainly due to accommodative monetary policy of global central banks, including an unexpected pivot away from interest rate hikes, to three rate cuts by the U.S. Federal Reserve.

Bonds delivered phenomenal returns in 2019

Bonds gained significantly in 2019 due to a combination of falling interest rates and strong investor demand for safe assets. Lower economic growth and inflation expectations contributed to significant declines in long-term interest rates worldwide, coinciding with the majority of global central banks cutting short-term interest rates. Meanwhile, global investor demand for bonds remained high throughout the year amid geopolitical uncertainty and recession fears. Investor appetite for safe income helped push bond prices higher, particularly for long-term government and high-quality corporate bonds.

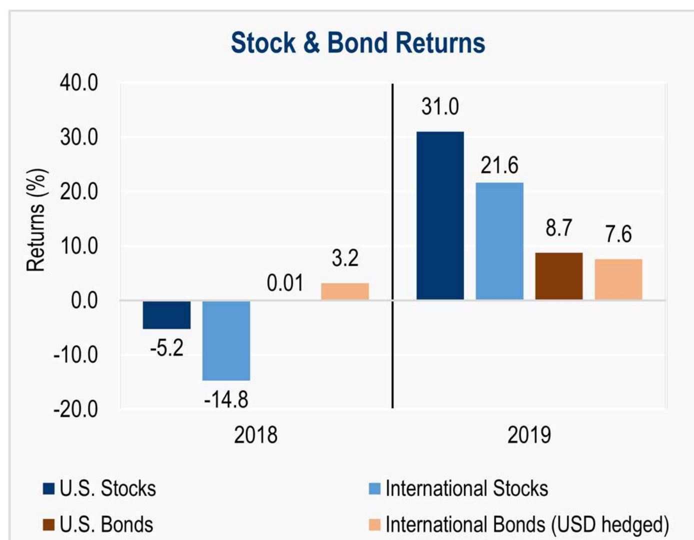

Figure 1. After a down year in 2018, stock markets around the world soared in 2019. Concerns about global trade and slowing economic growth were offset by a series of global government and central bank measures intended to boost economies and revive investor sentiment. Similarly, global bond returns were strong due to a combination of falling interest rates and strong investor demand for safe assets.

U.S. stock returns are represented by the Russell 3000 Index. International stock returns are represented by the MSCI ACWI Ex USA IMI. U.S. bond returns are represented by the Barclays Aggregate Bond Index. International bond returns are represented by the Barclays Global Aggregate Ex USA Hedged Index. Their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is not a guarantee of future results. Source: Morningstar, Russell, MSCI, Barclays. Data as of 12/31/2019.

Outlook for the markets is positive but subdued

The current environment for stocks is generally favorable. Given relatively easy financial conditions (i.e., lower interest rates) and a healthy economic backdrop, corporate earnings are forecasted to accelerate in 2020.[2] As such, positive stock returns are expected; however, given the significant increase in stock prices (and valuations) last year, gains are likely to be subdued this year. Stock market volatility will likely increase in 2020, as a myriad of global geopolitical issues and the U.S. presidential election cause investor sentiment to swing more widely than usual. Similarly, bond returns are expected to be positive but lower than last year, given that interest rates will likely remain low throughout 2020. Regardless, high-quality bonds will continue to be essential diversifiers in a portfolio.

Middle East tension not likely to derail markets

Similar to recent years, geopolitics will likely cause increased market volatility in 2020. Issues with Iran have been front and center to start the year, but so far have not caused significant disruption to the markets. However, Middle East tensions caused oil prices to rise, which brings up the question of how much this will negatively impact the U.S. economy and market. The answer is that the impact is a lot less than it used to be (15 to 20 years ago) when the U.S. was importing so much foreign oil. Today, the U.S. is one of the largest oil producers, which has significantly reduced its dependence on foreign oil and created a supply surplus around the world. Although the U.S. and other countries are not impervious to Middle East oil supply disruptions, the ramifications are much less significant today.

Economic Review & Outlook

U.S. economy supported by consumer spending

U.S. economic growth slowed but remained positive in 2019, despite concerns earlier in the year of a recession. Growth was pulled down by weak business investment and manufacturing activity, as uncertainty about a U.S.-China trade deal dampened corporate confidence. Fortunately, though, there was no apparent spillover from the manufacturing slowdown to the rest of the economy. Service sector activity, which accounts for over two-thirds of U.S. gross domestic product (GDP)[3], expanded as consumer sentiment and spending was (and continues to be) healthy. (See **Figure 2**.)

U.S. Consumer Sentiment & Spending

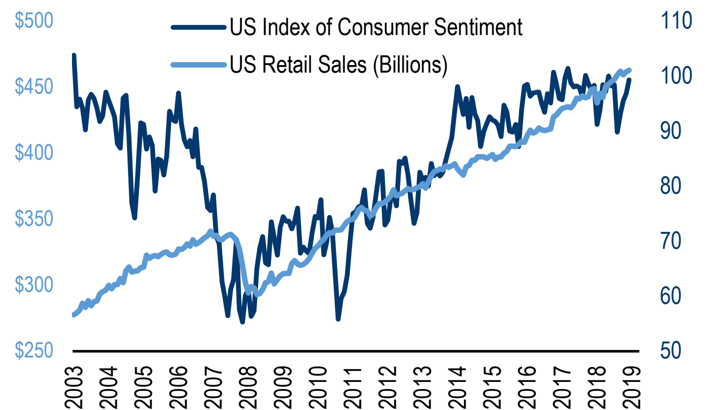

Figure 2. U.S. consumer sentiment is within reach of the highest readings since the early 2000's, resulting in strong retail sales.

Sources: Census Bureau, University of Michigan YCharts. Data as of 12/2019.

Trade tensions weighed on international economies

Global growth in 2019 likely grew at its slowest rate since 2008-09.[4] Rising trade barriers and associated uncertainty induced a slump in global factory activity and trade. Further pressure came from country and region-specific issues including: uncertainty around the U.K. leaving the European Union; recessions in some of the largest economies in the European Union (e.g., Germany and Italy); and an accelerating economic slowdown in China, which has also been facing major citizen protests in Hong Kong. Fortunately, central banks around the world remained committed to responding to economic weakness with new stimulus measures to boost growth.

Global economy is poised for a modest rebound

The global growth slowdown has likely neared a bottom, and the risk of a global recession has diminished. Continued central bank stimulus will likely stave off a global recession and eventually result in a pickup in economic activity once again. However, because many significant headwinds remain, the re-acceleration in economic growth will likely be modest at best. A preliminary U.S.-China "Phase 1" trade deal might stabilize corporate confidence. Still, a rebound in global manufacturing and trade will likely require a comprehensive trade deal on longer-term structural issues between the two economies; this deal continues to be more difficult to achieve. Regardless, macro-economic fundamentals in the U.S. will likely remain favorable, and the record-long expansion should continue for what will be its twelfth year by mid-2020.

Importance of Staying Invested

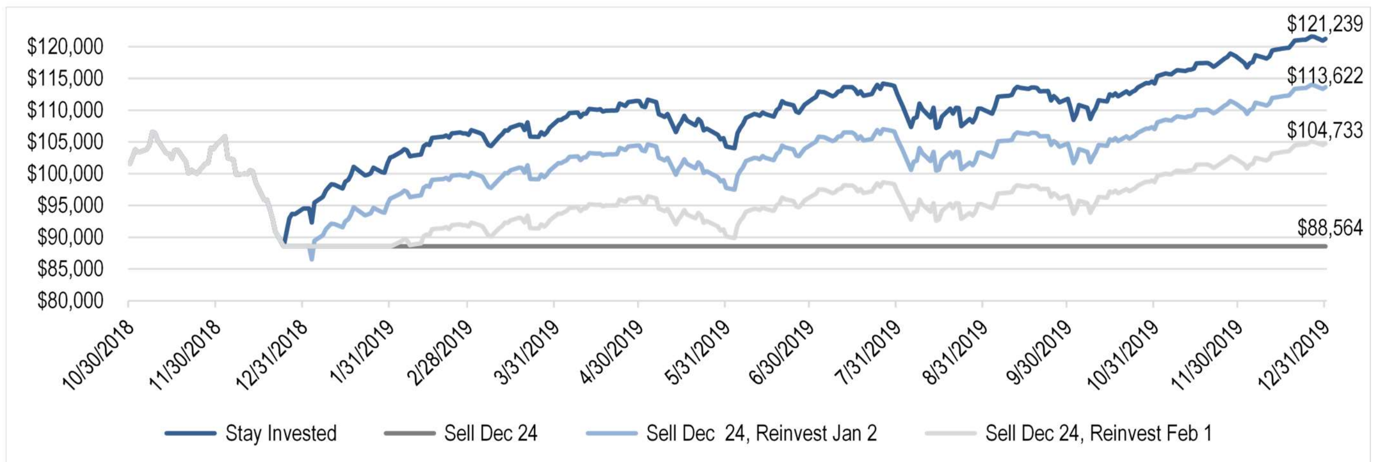

Figure 3. Data represents $100,000 portfolios at the start of October 30th, 2018 and invested in the Russell 3000 TR Index. A portfolio that sold to 100% cash on December 24th, 2018 lows would have generated a loss of 11.44%, whereas a portfolio that remained invested through December 31st, 2019 would have experienced a 21.24% gain.

Sources: Morningstar Direct. Calculations based on Russell 3000 TR Index.

On the Minds of Investors

Why should I stay invested?

After such a strong year for stocks with the U.S. stock market once again reaching new all-time highs, many investors are wondering whether they should stay invested. A common concern is that the stock market is likely to come back down from such a high current level, especially given the uncertainty surrounding trade policy, Middle East tensions, and the upcoming U.S. presidential election. This concern is a valid one, even during a bull market like the one we've experienced over the last eleven years. Since 2009 (the start of the recovery from the last U.S. recession), the U.S. stock market has experienced a greater-than-5% intra-year decline in ten out of the eleven calendar years, and a greater-than-10% intra-year decline in seven of those years.[5]

Over the last eleven calendar years though, the U.S. stock market ultimately delivered positive returns in ten of those years and is up nearly +351% during this period.[6] The stock market ultimately recovered despite the many stress points that plagued it at various points over the last decade. The most recent example was the realization of an economic slowdown that caused the sharp stock market sell-off in late-2018. This was a particularly severe situation because the growth scare permeated globally, creating a temptation for investors to sell stocks and avoid losses. Those investors that sold are likely regretting their decision today. (See **Figure 3**.)

As the data in **Figure 3**. shows, staying invested and ignoring the short-term volatility is often the best course of action. Trying to time the market is extremely difficult and is a strategy that, counter to its original intent, typically ends up hurting long-term portfolio returns.One of the principals of our philosophy is that most investors should stay invested for as long as possible. Although current market and economic fundamentals are solid and our outlook is generally positive, some things in the coming year will likely stress the markets or not go as expected; as such, we build diversified and balanced portfolios that can keep investors comfortable as the market goes through its ups and downs.

Portfolio Management

Portfolios captured most of the market returns

Despite a volatile macro backdrop, 2019 was a very good year for both stock and bond markets around the world. Capstone portfolios performed well, capturing most of the returns that markets delivered. Various strategic positioning helped portfolio performance, including overweights to U.S. stocks and bonds relative to international investments; an overweight to large-cap stocks relative to mid-and-small-caps; allocations to real estate and infrastructure sectors; and an overweight to long-term bonds relative to short-term bonds. Aside from these favorable positionings, our commitment to constructing portfolios with low-cost and tax-efficient investment funds helped clients to keep more of their returns.

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Growth and value stock positioning

One aspect of our strategic positioning that detracted from portfolio performance was an overweight to "value" stocks relative to "growth" stocks. We strategically overweight value stocks (companies that usually trade at lower low relative prices) because they tend to deliver better risk-adjusted returns over long periods.[7] However, growth stocks (companies that usually trade at high relative prices due to higher-than-average expected earnings growth) have significantly outperformed value stocks in recent years. The outperformance has been a result of strong earnings and high expectations. Most notable are the stocks commonly referred to by the "FAANG" moniker – Facebook, Amazon, Apple, Netflix, and Google– which have posted impressive gains through the years, and are now all worth many times their initial-public-offering prices.

Why an overweight to value stocks still makes sense

It is always tempting for investors to buy top-performing stocks after-the-fact. Unfortunately, research has shown no reliable way to predict which will be the top-performing stocks going forward; this includes the strategy of picking the best-performing stocks in the prior year(s). We, therefore, do not think it makes sense to change the value-stock overweight in portfolios despite recent growth-stock outperformance. In fact, based on today's relatively expensive valuations for many growth stocks, we think it still makes sense to have a little more high-quality value stocks in portfolios.

Sources & Notes

[1] Source: MSCI, Morningstar Direct. Global stocks as measured by the MSCI ACWI IMI Net-Return Index.

[2] Source: Factset. https://insight.factset.com/sp-500-earnings-preview-cy-2020

[3] Source: Office of the United States Trade Representative. https://ustr.gov/issue-areas/services-investment/services

[4] Source: International Monetary Fund. https://www.imf.org/en/Publications/WEO/Issues/2019/10/01/world-economic-outlook-october-2019

[5] Source: Standard & Poor's, J.P. Morgan Asset Management. U.S. stocks as measured by the S&P 500 Total Return Index.

[6] Source: Standard & Poor's, Morningstar Direct. U.S. stocks as measured by the S&P 500 Total Return Index, cumulative return from 01/01/2009 to 12/31/2019.

[7] Source: Dimensional Fund Advisors. Fama/French Three-Factor Model research.

Important Disclosure Information

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