CMH Wealth Management, LLC

Volume 13

*In this issue...*

- *Banner year in equities*
- *Macro events lead the way*
- *Fundamentals still matter*
- *Performance Commentary*

## Stretching Fundamentals

The equity market of 2019 produced its third strongest performance of the past 25 years as the S&P 500 was up 31.5%. This was within 2% of the highest annual return during this period (see table on page 2). Fixed income also provided strong returns, doubling existing fixed income yields.

Throughout the year financial markets focused more on macro-economic factors than on broad fundamentals. Positive macro factors included trade negotiation progress, lower personal income brackets, lower corporate tax rates, record low unemployment, lower interest rates, and continued economic growth, coupled with no recession. Avoiding a recession was a bonus that contradicted some economists' expectations.

The Fed delivered lower interest rates and abundant liquidity, which was a 180 degree change in its monetary stance from 2018. This Quantitative Easing (QE4) has not been fully acknowledged or admitted to as an existing policy.

While these positive macro characteristics led the equity market's strong returns, fundamentals did not provide as much support. The fundamentals pointed to a U.S. consumer that single handedly carried growth.

Corporate fundamentals delivered lower than expected earnings per share (EPS) growth, which did not support 31% equity market returns. This divergence resulted in a forward price earnings ratio (P/E) expansion from historical averages of 16 to a more expensive valuation at 18.

The focus on headlines reminds us of prior year events that had a short-term impact:

2018—S&P 500 sold off 20% on recession fears

2016—Brexit begins

2015—U.S. dollar spikes, oil prices crash

2011—S&P downgrades U.S. Treasury rating

We manage through these events with a focus on fundamentals and the risk parameters that match each client's longer-term goals.

The decade ended with an annualized return from the S&P 500 of 13.6%. The only negative calendar year came in 2018. It's not surprising that these higher-than-average returns followed the market upheaval of the late 2000's.

## 2020 Market Themes

**Domestic Market Dynamics**

- election year climate elevates policy uncertainty
- trade used as lever to further global interests
- trade talks impact domestic growth goals
- interest rates materially impact equity returns

**Late Stage Economic Growth**

- low economic growth with GDP in 2% range
- this economic growth is well below 2.7% avg
- non-consumer GDP detracts from growth
- weak business investment and manufacturing
- consumer is strong but improvements limited
- extremely low unemployment of 3.5% exists
- continued monetary easing is a longer-term risk

**Monetary Policy Tailwind**

- Federal Reserve (Fed) will try to hold rates steady
- Fed accommodation lasts longer than expected
- higher rates hurt growth at current debt levels
- global central banks continue to underwrite investment sentiment
- yields pressured by continued demand for income
- lower for longer rate environment

**Fiscal Policy Headwind**

- significant intertwined political/fiscal risks remain
- budget deficit grows, adding to policy pressures
- Federal net debt at 70 year high as % of GDP
- government debt growth could push rates higher

**Profits vs. Valuations**

- attractive equity valuations limited
- wage inflation weighs on profits
- debt levels limit productive growth potential
- default risks rising but still lower than average
- reduced emphasis on shareholder distributions
- priority on strong balance sheets
- increased focus on corporate free cash flow

S&P 500 ANNUAL RETURNS LAST 25 YEARS

| Year Ending | Total Return Change |
|---|---|
| 2019 | 31.5% |
| 2018 | -4.4% |
| 2017 | 21.8% |
| 2016 | 12.0% |
| 2015 | 1.4% |
| 2014 | 13.7% |
| 2013 | 32.4% |
| 2012 | 16.0% |
| 2011 | 2.1% |
| 2010 | 15.1% |
| 2009 | 26.5% |
| 2008 | -37.0% |
| 2007 | 5.5% |
| 2006 | 15.8% |
| 2005 | 4.9% |
| 2004 | 10.9% |
| 2003 | 28.7% |
| 2002 | -22.1% |
| 2001 | -11.9% |
| 2000 | -9.1% |
| 1999 | 21.0% |
| 1998 | 28.6% |
| 1997 | 33.4% |
| 1996 | 23.0% |
| 1995 | 37.6% |
| Avg. Annualized | 10.2% |

*Table Source: S&P Dow Jones Indices*

## 2019 Benchmark Index Performance

| Asset Class | 2019 | As Measured By |
|---|---|---|
| Fixed Income | | |
| Investment Grade Short | 4.0% | BB U.S. Gov/Credit 1-3 Year |
| Investment Grade Municipal | 6.7% | BB Muni Bond 7 Year |
| Investment Grade Taxable | 8.7% | BB U.S. Aggregate Bond |
| High Yield Bond | 14.3% | BB U.S. Corp High Yield |
| Global Bond | 5.1% | BB Global Bond Agg X-US |
| Equity | | |
| Large Capitalization | 31.5% | S&P 500 |
| Large Capitalization Growth | 31.1% | S&P 500 Growth |
| Large Capitalization Value | 31.9% | S&P 500 Value |
| Small & Mid Cap (SMID) | 27.7% | Russell 2500 |
| International Equity | 21.5% | MSCI ACWI X-US |
| International Developed | 22.0% | MSCI EAFE |
| International Emerging | 18.4% | MSCI Emerging Markets |
| Preferred Stock | 17.6% | S&P US Preferred Stock |
| Gold | 18.9% | S&P GSCI Gold Spot Price |

*Data Source: Tamarac and providers to Tamarac. Total returns.*

## 2019 Performance Commentary

We ended 2018 with a discussion on the negative or muted performance across most asset classes. After a series of rate increases in 2018, the Fed reversed course and cut rates in 2019. The "R" word (recession) was on the tip of every tongue, but the accommodative stance from the Fed helped to calm nerves. As seen in the table above, all major asset classes produced strong positive returns last year.

The optimism of investors was a sight to behold. Weak growth and disappointing manufacturing numbers would weigh on markets only briefly. Equity markets focused more on rate cuts and hints of positive trade discussions. Corporate profits declined while U.S. equity valuations moved above historical averages. This is an indication of confidence in and quality of the U.S. market, along with its higher growth-oriented sectors.

Low economic growth and Fed rate cuts sent 10-Year U.S. Treasury yields tumbling from 2.8% to 1.5%, before ending the year at 1.9%. This movement drove strong performance across fixed income, particularly longer-dated securities. Fixed income performance could soften as current yields are the best predictor of long-term future returns.

The length of this current economic recovery has led to many recession predictions over the past few years. Investors should remember recessions are typically initiated by excesses (not a current known problem), financial market imbalances leading to high leverage (potential current problem with elevated corporate and government debt), or external shocks, such as high oil prices, which are hard to predict.

In summary, risks were heightened entering 2019, but accommodative monetary policy and the strength of the consumer won the day.

## Portfolio Positioning

**Asset Allocation**

Our asset allocation continues to favor equities over bonds, but to a lesser degree than last year. Within equities we remain slightly overweight to U.S. large caps. This positioning reflects a risk reduction by favoring large companies over small companies, and strong U.S. growth prospects relative to international.

Within fixed income, we extended duration (longer maturities) before the decline in bond yields. This was a strong contributor to performance in the year. Performance will fluctuate as yields increase or decrease, but building income into the portfolios will provide consistent cashflow to re-invest or provide liquidity.

**Equity Sector Commentary**

Entering 2020, we continue to position our portfolios with growth equities at reasonable long-term valuations. In a low growth environment, these companies should continue to grow faster than the overall economy.

We maintain our favorable view of the technology sector, with an additional positive view on the healthcare sector. This is expressed with our overweight positioning. Our positions in these sectors have broadly grown revenue and earnings without reaching expensive valuation levels. While economic growth may be low by historical standards, growth in these sectors remains robust.

We are cautious on some defensive sectors as their growth prospects and intrinsic valuation are less attractive. We recognize that some energy stocks are undervalued. Any current energy investments are biased towards companies we view as higher quality. The market is pricing energy companies as if oil is below $30 a barrel (currently in the $60's) and world demand will be non-existent in 20 years. We disagree with this extreme thesis and see it as an opportunity.

We remain focused on companies with strong growth prospects, consistent earnings/revenue, secular growth themes, stable and growing cash flow, and durable balance sheets. We favor technology companies focused on cloud, data analytics, electronic payment processing, and artificial intelligence. Our healthcare investments emphasize strong brands and pipelines, pricing power, vertical integration, and life sciences exposure.

## Summary of Tactical Views

| Asset Class | Current Tactical View |
|---|---|
| Cash | Neutral from overweight. Money market yields have declined with each rate cut. Early in the year, we moved from floating-rate money markets to short duration U.S. Treasuries to lock in higher yields and maintain liquidity. |
| Fixed Income<br>Investment Grade<br>High Yield | Remain underweight & defensive. We have a reduced allocation toward direct high yield (higher risk) exposure and have moved up in bond quality. Our interest rate sensitivity is neutral in order to lock in income for our portfolios. We have also increased our positioning in preferred securities in order to lock in yield. |
| Equity<br>Large-Cap<br>Small & Mid-Cap<br>International | Remain overweight. Overall, the overweight to equities is marginal. Our portfolios are overweight U.S. large cap equities, while underweight U.S. small/mid cap and international equities. Entering 2020, our portfolios are positioned more overweight emerging market equities relative to international developed. |

Tactical views are focused on the shorter-term market cycle defined as the next 3 years. Strategic views are the underlying investment discipline focused on longer-term market cycles up to 10 years.

## Summary

**Key Market Dynamics**

1. **Late Stage:** This stage of the economic cycle continues to suggest caution. Investors should resist the urge to be overly aggressive. Debt accumulation and asset inflation are fueling economic activity and sentiment. Productivity growth and demographics are now less supportive of fundamental growth.
2. **Monetary Policy**: The Federal Reserve tried to move rates higher but capitulated to market pressure and lowered the Fed Funds rate in 2019. Expect rates to remain low for the foreseeable future and bond purchases to remain a monetary tool. This will limit the Fed’s ability to provide support in a downturn.
3. **Fiscal Policy**: The consumer is in a strong position but government deficits continue to rise. Budget deficits have increased from $779B in 2018, to $960B in 2019, with the 2020 estimate set to surpass $1 trillion. The level of debt needed to support these deficits, and the accompanying interest payments, elevates the risks for any future interest rate increases. Estimates show a 1% increase in rates, higher than projected by the Congressional Budget Office (CBO), will cost an extra $1.9 trillion over 10 years.
4. **Inflation and Yields:** Inflation will remain subdued as technology improvements continue to drive prices lower. The current low yield environment may persist for the foreseeable future. Flatter yield curves and lower long rates are the result of elevated debt levels, monetary stimulus and a demographic demand for income.
5. **Valuations/Fundamentals**: Attractive valuations in equity markets are limited entering 2020. Valuations in equities are more attractive than fixed income. Emerging markets offer opportunity should sentiment remain stable and the dollar’s strength subside.

Over the past 20 years, six of the ten best days in the stock market have occurred within two weeks of the ten worst days. Attempts at avoiding the worst days will likely leave an investor missing some of the best days. Even secular (decades long) bull markets have short-term recessionary set backs.

Please feel free to reach out with any questions or comments. We would love to hear your thoughts.

Author

John Fredette, CFA®
Portfolio Manager

johnf@cmhwealth.com

603-379-8161

Author

Thomas Burleigh, CFP®
Wealth Manager

tomb@cmhwealth.com

603-379-8161

155 Lafayette Road
3rd Floor, Suite 7
North Hampton, NH 03862

## Numbers Talk: 0 1 2 3 4 5 6 7 8 9 10

### Numbers help tell a story … Inserted for your reading pleasure

**A decade … by the numbers:**

1. July 31, 2019—Fed lowers interest rate for the first time since the financial crisis in 2008
2. First calendar decade since the civil war where the U.S. did not experience a recession
3. 13.6% - S&P 500 annualized return from January 2010 through December 2019
4. The S&P 500 is up 498% from its low on March 9, 2009 through December 31, 2019
5. Since 2007, total global debt has increased by 110% while GDP only increased 47%
6. CBO 2010 projection of 2019 fiscal year budget deficit: $765B, while actual was $984B
7. Unemployment rate moved from 9.9% at the beginning of the decade to 3.5% at the end
8. Historical average unemployment is 6.2% with a high of 25% in 1933
9. From the beginning of the decade to the end, gas prices only moved from $2.61 to $2.57: -4₵

**Markets and more:**

1. Since 1928, median annual S&P 500 return with a divided vs. unified government is 11% v. 8%
2. S&P 500 profit margins remain elevated at 11.2%
3. Forward Price/Earnings of S&P 500 is 18.2 compared to 16.3 (25 year average)
4. Average dividend yield of S&P 500 is 1.9%
5. 10 Year Treasury Yield 12/31/19: 1.9% nominal with 2.3% inflation equals –0.4% real
6. Avg 10 Year Treasury Yield (1958-2019): 6.0% nominal with 3.7% inflation equals 2.3% real
7. Inverted yield curve occurs on March 22, 2019, when yield on 10 year UST drops below TBill
8. January 25, 2019—longest ever U. S. government shutdown ends after 35 days
9. Since 2016, U.S. oil production grew 43% while OPEC production is down 8%
10. At age 65, the probability of living to age 90 is 23% for men and 34% for women

Sources include: Gluskin Sheff, *Breakfast with* Dave, 2019 Various Issues. CreditSuisse, *Investment Outlook 2020*. Goldman Sachs, *2020 U.S. Equity Outlook,* November 25, 2019. Goldman Sachs, *Global Economics Analyst, A Break in the Clouds*, November 20, 2019. Lord Abbett, *2020 Investment Outlook*, December 9, 2019. Schwab Investing Insights, *2020 Market Outlook,* December 6, 2019. Schwab Market Perspective: *Are We There Yet?,* December 6, 2019. JP Morgan Asset Management, *The Investment Outlook for 2020*. JP Morgan Asset Management, *Why Should I Stay Invested?*, January 3, 2020. JP Morgan Asset Management, *Guide to the Markets*, December 31, 2019. Data source providers include Thomson Reuters, S&P Dow Jones, Tamarac, U.S. Energy Information Administration (www.eia.gov), Committee for a Responsible Federal Budget (www.crfb.org), Congressional Budget Office (www.cbo.gov), and providers to.