TRAPHAGEN
CPAs & WEALTH ADVISORS

2019 Market Review & 2020 Outlook

2019 Economic & Market Review/Comments

2019 was one of the best years the broad financial markets have had in the past 20 years. It is rare that all bond types, real estate, alternative investments, and global stocks have a strong positive year. It was the best year for US stocks since 2013 and the best year for the US bond aggregate since 2002.

Was this remarkable financial market performance caused by higher global economic growth or fast-growing corporate earnings? Oddly, quite the opposite; US GDP slowed materially from 3% in 2018 to near 2% in 2019. In addition, US companies experienced no earnings growth year over year, with modest growth pegged for 2020 as well. In our opinion, there is little doubt a historic drop in mid/long term interest rates (10-year Treasury dropped from 3.2% to 1.8% in one year) and the FED pivoting in late 2018 to a rate cutting stance were the main drivers of financial market returns during the year. 'Do not fight the Fed' is a long-standing Wall Street saying, and 2019 was the banner year to prove it's worth.

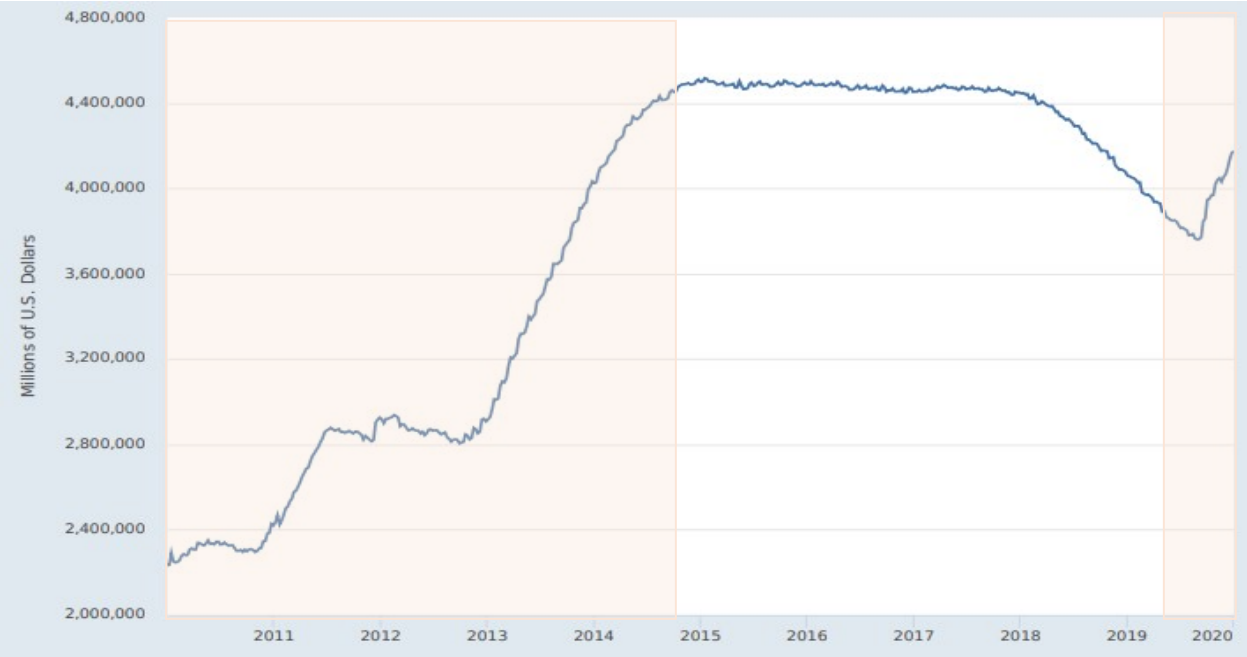
Select 2019 Asset Class Returns	
US Large Cap Stocks (IVV)	+ 31.3%
Pipeline Companies (TPYP)	+ 23.1%
Foreign Developed Equity (IEFA)	+ 22.7%
US Small Cap Stocks (IJR)	+ 22.4%
Emerging Market Equity (IEMG)	+ 17.5%
Investment Grade Bonds (LQD)	+ 17.2%
High Yield Bonds (HYG)	+ 14.2%
Diversified Real Assets (VCRRX)	+ 8.5%
Mid/Long Treasury Bonds (IEF)	+ 8.2%
TIPS (TIP)	+ 8.2%
Private Real Estate (TIPWX)	+ 7.6%
Municipal Bonds (MUB)	+ 7.1%
Alternative Lending (LENDX/RSF)	+ 3.7%
Insurance Securities (XILSX/SRRIX)	+ 0.9%

- *GPB, Mosaic, KKR, & Blackstone performance discussed in detail on page 6/7*

Traphagen strongly believes much lower interest rates and the FED's abrupt change in policy are the most important reasons for 2019's stellar market performance, but there were other contributors as well.

Positive 2019 Developments Outside of Rates
1- FED reinitiating the policy of balance sheet expansion
2- Likely agreement with China with 'Phase 1' trade deal
3- Very strong US consumer health and confidence
4- Likely ratification of 'USMC' with Mexico/Canada
5- Low inflation and extremely low unemployment
6- Chances for recession in 2020 decreasing

Below: ***US Fed Balance Sheet Size (Trillions of USD)*** *There is a high correlation between the direction of US balance sheet size and overall stock market performance*



The above graph should hammer home the point that although earnings and economic growth are very important long-term economic data points, in the shorter-term FED policy usually trumps all else. At the end of 2018, the stock market was down 20% and investors were scared as the economy slowed and the FED stated they were going to continue their rate hiking policy and balance sheet contraction.

Around Christmas of 2018, the FED seemed to have gotten the market's message, and communicated they were done with hikes and could be in position to reduce rates in 2019. Additionally, they recommenced their balance sheet expansion (which is

essentially a form of quantitative easing). From the final days of 2018 through the first of 2020, global risk and bond markets responded feverishly.

Not all was perfect through the year however, but the market ignored or moved past all the below risks/concerns as 2019 concluded.

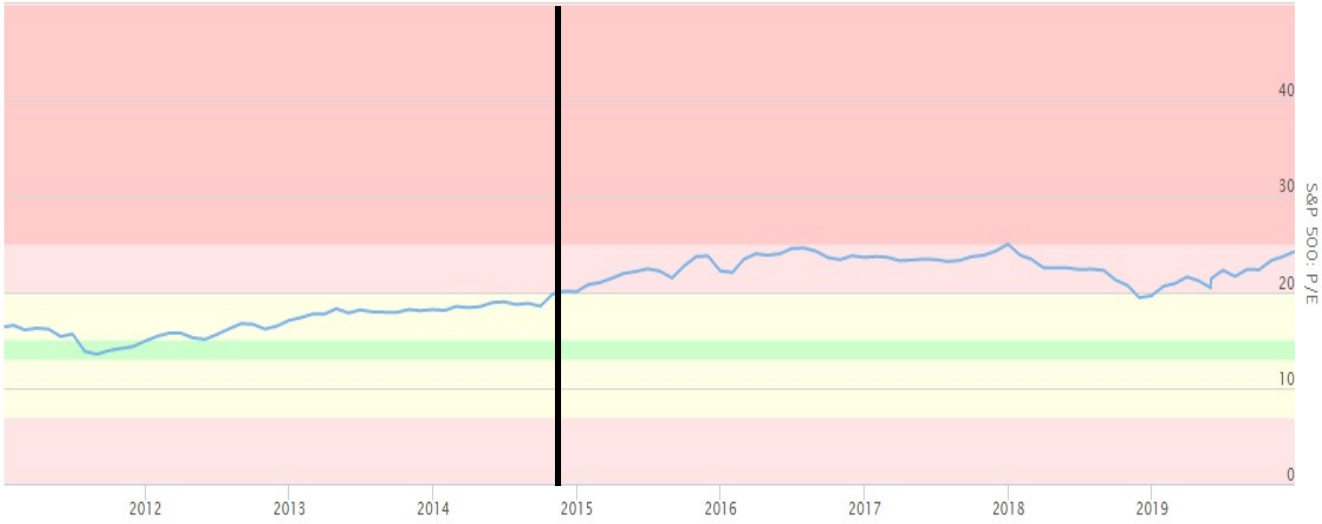
Yield Curve Inversion/Recession Fears: For the first time since 2007 the US yield curve inverted in 2019 (meaning short term interest rates are higher than longer term rates). Historically this has been a strong predictor of significant economic slowdowns or even recessions. Seemingly, the FED recognized this market signal, and after reducing rates, 'un-inverted' the curve, and although we do not yet know, it seems likely they did this in time to avoid a recession.

Above: *Chart of the spread between short term rates and the 10 Year Treasury. Highlighted in red is the first inversion since 2007. Since mid-2019 we have 'un-inverted' with slightly higher long-term rates and lower short term.*

China Trade Concerns: Throughout most of the year up until October/November China trade headlines/tweets seemed to cross every day and had a significant impact on the markets in short order. There was a large concern tariff burdens were going to keep increasing, especially on consumer goods and that the situation would continue to escalate. However, starting in October 2019 the narrative began to change and progressively got more positive. As we write this update it is expected that the US and

China will sign a 'phase 1' trade deal within a couple weeks which should, at the very least represent a 'cease fire' in the trade war that was being 'fought' since early 2018.

Global Economic/Earnings Slowdown: Both global corporate earnings and GDP growth slowed significantly in 2019 vs. 2018. Within the US, GDP shrank from a robust 3% to around 2%, and corporate earnings were essentially flat. This compares to red hot earnings growth of over 25% in 2018 vs. 2017 on the back of tax reform. Despite this, with much lower interest rates and supportive central bankers across the globe investors were willing to pay more in price for each dollars' worth of corporate earnings and thusly we have seen a large increase in stock market valuation.



Above: *Chart of SP500 Price to Earnings ratio over past 10 years. Since 2015 we have been in a 20 – 25 range; after last year's significant price gains we are currently at the upper end of that range.*

Geopolitical Concerns/Impeachment: Several political issues arose in 2019 including the US House of Representatives impeaching President Trump, a UK Vote which essentially ensures Brexit within a couple months, and most recently a significant escalation of Iran tensions with the assassination of General Soleimani. We do view the first two issues as presenting very little long term risk, as it is virtually certain the Senate will not vote to convict and after years of Brexit suspense we think a 'semi-orderly' final separation from the EU will be somewhat of a relief. Iran of course is a concern if we move closer and closer to an outright larger scale military conflict, but even here we think the economy and markets will be ok.

Traphagen 2019 Portfolio Comments & 2020 Changes

After a tough 2018, portfolios and essentially all asset classes and securities within them roared back with a vengeance. Again 2019 turned out to be the best year in the stock markets since 2013 and the best year on average for our clients since either 2013 or 2009 depending on risk level.

Two out of the three 'legs' in the portfolio stool performed extremely well and significantly above targets, with the other (alternative investments) returning just under our long-term target of 5%. with no/little volatility or correlation to other financial markets.

US large cap stocks, powered by the Technology sector had its best return since 2013 with pipeline companies, small cap stocks, foreign developed stocks, and emerging stocks lagging, but still preforming very well with returns in the upper teens to low 20 percent range.

All classes of bonds with the double tailwind of a historic reduction interest rates and compressing credit spreads had the best year since 2002. Bond returns ranged from 7% to 17% with investment grade bonds being the best of the bunch.

Overall, alternatives had a mixed year (returning an aggregate ~ 4.5%; our long-term target is 5%), with individual alternative classes performing between -2% and +10%.

You will find a summary of major changes we made to portfolios during 2019 and our comments on each investment.

- **Allocation to Bluerock Private Real Estate Fund (TIPWX):** We allocated to our first private real estate equity fund in January/February of 2019. This is a nationally diversified fund which invests in a mix of office, multi-family, industrial, and retail real estate properties across the country. We are very happy with this fund as it returned 7.5% with virtually no volatility. In addition, it generates a nice rental cash flow yield.

- **Allocation to Private Municipal Bonds (TSIFX):** We added an allocation to the Tortoise Social Infrastructure Fund, which is a fund of private municipal bonds from across the country. Their main focus is on charter schools, healthcare facilities, and senior living centers. These are short term loans with very little sensitivity to interest rates and are collateralized by the underlying cash flow and/or real estate. During 2019 this fund returned 4.1% (or the equivalent of 5.6% on a 25% tax adjusted basis), and we hope in future years we can average 5% or more on an after-tax basis.

- **Further Reduction in Foreign Stock Investments:** On the back of a 50% trim in 2018 of our emerging stock exposure, we completely eliminated our emerging allocation and trimmed our foreign developed by 50% in mid-2019. We continue to see better corporate governance/accounting standards, an improved tax structure, and more growth/technology exposure within our own borders. It should be noted however, we could take a tactical/short term foreign position at any time if we see opportunity.

- **Addition of US Stock Sector Rotation Strategy (DSEEX):** In September of 2019 we introduced a sector rotation strategy within our US large cap stock asset class. This is a Doubleline fund which invests in 4 out of the 5 'cheapest' stock sectors and reevaluates and rebalances (if warranted) each month. In addition, to enhance the cash flow yield it also has a fixed income component, so while the SP500 yields around 1.6%, this fund has a payout of 2.7%. Since purchase, the fund is up roughly 7%.

Private Investment Update *(for $1M+ Traphagen/Accredited clients only)*

Private Equity (GPB Capital): Although certainly slower than we would like, significant progress was made in 2019, and that continues as we head into 2020. We are awaiting Eisner to announce a definitive date for audit completion, but our best estimate at this point is sometime between late Q1 and mid Q2.

Significant changes have been made in terms of leadership over the past couple months as well. GPB has recently hired a permanent CFO, constituted an independent corporate level board of directors, an completely independent audit committee (all CPAs), a new COO, and a permanent CEO with the auto division (Prime Auto). We feel these hires are undoubtedly a positive for investors and company operations. The new CEO of Prime Auto, Todd Skelton, has been with AutoNation (NYSE: AN) for 24 years, most recently the president of their north eastern division.

Lastly, in terms of operations and company performance the improvement from the 1st half of 2018 through the 1st half of 2019 outperformed GPB's internal estimates. To take the auto division as an example, (it does represent the largest piece of the fund) pre-tax profit increased from $9.6M tin the first half of 2018 to $21.1M in the first half of 2019 (or a 120% increase year over year).

We continue to monitor this investment and are hopeful that 2020 will bring a reinstatement of dividends, a completed audit, and further operational/performance improvements.

Private Real Estate Credit (Mosaic): We remain extremely pleased with Mosaic, as it has returned 9.5% in 2018 and should return around 10% in 2019. These returns were earned with no volatility of correlation to the bond or stock markets. They continue to grow their fund, and one of their premiere projects (Ritz Carlton in Portland, Oregon) is moving forward nicely.

Private Equity (Artivest KK Private Equity Fund): Our first clients entered this fund beginning November of 2019, and so far we are pleased with a 0.6% return in the month, while we await the final December return. Most likely the fund will return between 8% and 8.5% for 2019. This fund provides broad exposure to private equity across both the United Stated and abroad.

Private Real Estate Equity (Blackstone BREIT): Over the next couple months we will be starting to allocate funds for some clients into the Blackstone BREIT. This is a large fund that holds industrial/warehouse properties (mainly used for ecommerce) and multi-family real estate across the nation. This investment produces 5.5% (paid monthly) in rental cash flow along with the chance for price appreciation. For 2019 the fund returned 11.5%.

2020 Portfolio & Economic Commentary

After the very impressive returns for all assets in 2019, we expect much more muted returns in 2020. As opposed to valuation/multiple expansion and interest rate reductions to produce returns, we will need to rely on actual cash yields, continued liquidity being provided by the FED, and some modest earnings growth.

2020 Portfolio Changes
Eliminate 'SRRIX' in favor of 'XILSX' (Insurance Securities)
Eliminate 'RSF' in favor of 'LENDX' (Alternative Lending)
Possible Allocation to Blackstone BREIT for $1M+ clients
Allocation to KKR Private Equity Fund for $1M+ clients
Possible addition of Vanguard Mid-Cap Fund
Trim of mid/long term bonds after outsized gains

The four main themes regarding the above 2018 portfolio changes are:

1- Taking profits in mid/long term bonds that have had outsized returns in 2019 as a significant further reduction in interest rates or more spread tightening for corporate bonds is not expected

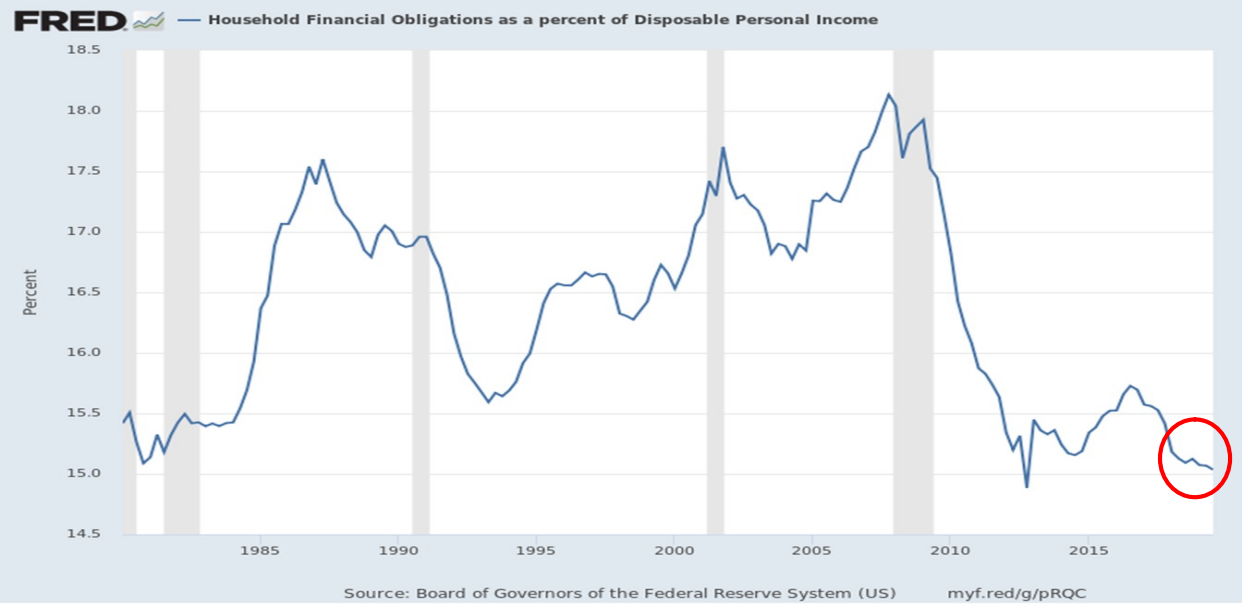
2- Refining our alternative investment exposure as we concentrate on two funds that have proved their worth over the past 3-5 years as outperformers (LENDX & XILSX)

3- After a year of research and forming a symbiotic relationship with two of the premiere private investment firms in the country (KKR & Blackstone) we are excited to offer a diversified private equity fund & private real estate fund to our $1M+ clients.

4- Late in 2019 Fidelity has eliminated all commissions on stock and ETF trades. This opens up our commission free investment universe to 1000s of additional products, and we are beginning the search for any superior funds within traditional asset classes that prior to this change would not have made sense.

When looking at the short to intermediate term outlook for the US and global economy there is a mixed to relatively optimistic picture.

We continue to see one of the best employment environments in the past 80 years with a 3.5% unemployment rate, continued robust job growth, and for the first time in many years some real increases in wages across all salary levels. The US consumer continues to be in a great position in almost all aspects.



Above: *Past 40 years of total household debt as a percentage of disposable income. The lower this ratio is (which we are now at historic low); the easier it is for consumers to pay their total debt obligations.*

In addition to a very healthy US consumer, with the reduction of trade tensions with China and with a still slow, but more stabilized global outlook, we see US economic

growth as muted, but still positive in 2020 (our estimate is in the 1.6% to 2.1% range). This along with a still accommodative FED, supports in our opinion financial market strength.

Below we have highlighted what we feel are the major risks for the markets in 2020

2020 Stock Market/Economic Risks
Change in FED Policy to less accommodating stance
Materially higher interest rates/inflation
2020 Election Uncertainty
Flat or declining US Corporate Profits
Re-escalation of China Trade War

Traphagen is starting to prepare several different portfolio repositioning strategies for the 2020 election. Depending on who is likely to win the democratic nomination and the likely outcomes of the general and Congressional elections will determine our portfolio direction to some extent within the year.

In addition, we will continue to monitor interest rates, inflation, any changes to FED policy, and trade progress with China through 2020.

Our Traphagen Recession Index (TRI) is signaling a ~ 35% change of recession over the next 12 months, which is somewhat elevated, but still much lower then readings we saw just 3-4 months ago. **Our TRI hit 58% (all time high) in mid-2019, before reversing course and it continues to decrease into 2020, giving us more confidence as we enter the new year.**

We wish you and your family a healthy, happy, and prosperous 2020! As always, remember that your Traphagen advisors are monitoring your portfolios and are confident **they are positioned for both asset protection and good long-term returns**. **We appreciate the continued confidence and trust you have placed with us.**

Best regards,

Your Traphagen Investment Team