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FINANCIAL MANAGEMENT, INC.

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2019 – Year End Review

The Bulls and Bears Played Nicely Together

Through the end of the year, a **100% stock portfolio with 20% invested in international returned 29.19% with dividends reinvested**. **Intermediate term bonds were up 9.16%** (Barclay's Aggregate Bond Index) and short-term bonds were up 3.64% (S&P Short Term Bond – Gov't/Corporate Index).

Let's try to make sense of this unlikely outcome with both stocks and bonds up strong for the year. Even in retrospect that is a difficult task. **One needs to think of 2018 and 2019 as one time period for measuring performance. Over the two-year period, stocks were up 9.37% annualized and bonds as measured by the Barclays Aggregate Bond Index were up at a 4.49% annualized rate.** This is more in line with long term expectations for both asset classes.

The detail (skip ahead to key take-aways in order to avoid the detail): In 2018, corporate earnings performance was phenomenal as comparisons to the previous year were easy given the advantage afforded corporations with the 2017 tax code change. Despite two Federal Funds rate increases by the Federal Reserve through June and one expected in September, a 100% stock portfolio was up 8.15% through August 28, 2018. The FED followed up with two more increases in September and December. By year end, a 100% stock portfolio was down 7.51%. Measures of the economy and earnings gains were solid. Nerves were being frayed by the FED's four rate increases for the year and the uncertainty surrounding the U.S. – China trade battle and Brexit. Also, the FED's rate increases (and forecast of two more in 2019), drove bond prices down (offsetting bond income) and the Barclay's intermediate bond index was up 0.01% for the year. **In 2019**, the stock market recognized the 4th quarter 2018 stock decline was not in line with reality and stocks were quickly off to the races. Foreign demand for U.S. bonds rose with interest rates (the 10-year Treasury yield touched 3.25% in late September 2018), driving bond prices up (yields down). In July, September, and October, the FED reduced interest rates at total of three times. This sealed the deal for the bond market rally in 2019. Meanwhile, stocks continued to melt up, apart from the late August through September period, when the stock market became worried about the U.S. Treasury yield curve inversion (short term interest rates higher than intermediate and long-term rates). **The yield curve quickly steepened with two Federal Funds rate reductions in September and October (the FED to the rescue).** Rounding out the year, the lifting of a significant portion of uncertainty regarding Brexit and news of a Phase 1 trade deal with China led to an acceleration in the stock market melt up through the end of 2019.

Key take-aways:

1. Major governmental and Central Bank (U.S. and International) moves including the 2017 tax code change, trade battles, Brexit, quantitative easing (Central Bank purchases of bonds to put money into the economy and to lower interest rates), interest rate suppression (direct central bank action to lower interest rates to make borrowing cheap to stimulate commerce and to force risk taking in investments), and negative interest rates (Europe) have placed a heavy hand on investment decision making.
2. These actions are causing a myriad of affects. Investors are forced to take higher risk in all asset classes.
3. Negative interest rates in Europe are confounding U.S. Federal Reserve policy via spillover impact on U.S. interest rates, possibly causing false U.S. Treasury yield curve inversions.
4. The testing of lower bounds on interest rates is problematic for banks (especially in Europe with negative interest rates) and risks limited protection in the next downturn as bond counterbalancing of stock declines would be limited.
5. Business leaders are hand tied by uncertainty and breadth of possible policy outcomes.
6. In the meantime, the risk-taking is being rewarded to possibly unsustainable levels.

7. Progress has been made in U.S. – China trade fight and Brexit, but there is a long way to go in the trade battle negotiations and the U.K. – Eurozone rules of travel and trade beyond 11/30/20 are not yet hammered out.

Despite positive stock market returns, the evidence of tenuousness remains in this ten plus year bull market. In 2019, $500 billion had been added to cash accounts, $515 billion had been added to bonds, and the pool of equity, alternative, and commodity investments had declined by $110 billion.

Although a lack of business investment was a drag on economic growth last year, **record stock repurchases by corporations certainly enhanced stock return.**

Growth stocks outgained value stocks for the year by 9.73%. Therefore, value stocks trailed all stocks by 4.87%.

At the year end, price to book value of growth stocks was 8.28. This is 71.4% above the long-term average of 4.83. Price to book value of value stocks was 2.18. This is 7.4% above the long-term average of 2.03. Valuations for growth stocks and value stocks remain in stark contrast.

Valuations for growth stocks are very stretched. Continued stock price gains should be dependent upon healthy gains in earnings. A loss of investor confidence could easily cause a drawdown in stock prices. For example, in the depth of the yield curve inversion in late August and the month of September, growth stocks declined while value stocks were positive and outgained growth stocks by 3.8%.

China trade: The trade negotiations with China have reached an inflection point. The escalation of trade penalties from both sides has given way to an incremental approach to working through issues. The phase 1 agreement was signed on 1/16/20. Key points include: a requirement for China to increase purchases from the U.S. ($200 billion over two years) and increase agricultural purchases from the U.S. (additional $32 billion per year), language regarding trade secret theft, creation of a dispute resolution office, stipulations for removal of barriers to entry into China for U.S. financial services, tariff relief on both sides, and an agreement from China regarding currency manipulation. The U.S. still has tariffs in place on $370 billion worth of Chinese goods with an intention of using the tariffs as leverage towards firm commitments regarding elimination of forced technology transfer, elimination of technology theft, and open markets for foreign corporations in China.

Macroeconomics / U.S. and World Economy

U.S. First through fourth quarter real GDP growth rates, 3.1%. 2.0%, 2.1% and 2.1%, beat updated expectations. For the year, real GDP growth was 2.3%. GDP was hindered by the reduction in corporate investment as a result of the U.S. – China trade dispute. Estimates by business groups, the Federal Reserve and the International Money Fund (IMF) for U.S. GDP growth for 2020 coalesce around 2%. **For 2019, corporate earnings comparisons were more difficult given the boost provided by tax reform in 2017 and 2018.** That said, 75% of companies in the S&P 500 beat consensus earnings estimates in the 3rd quarter and 4th quarter. This is an above average result. Expectations are for a gradual increase in earnings growth through the year 2020, likely arriving at around 10% by the 4th quarter **from 0% growth in earnings in 2019**.

Euro area GDP slowed to 0.4% (annualized) in the 4th quarter (lowest in seven years) and was 1% for the year 2019. Euro area GDP growth forecast for 2020 is 1.3%.

U.K. Brexit deliberations led to significant uncertainty for the U.K., Europe, and the world in 2019. The uncertainty took its toll in the 4th quarter, with 0% GDP growth for the quarter. On the year, real GDP growth was 1.4%. The U.K. officially left the Eurozone on 1/31/20. Life and business will continue as is at least until 11/30/20 when a new arrangement between the U.K. and the Eurozone is to be in place.

Japan's GDP declined at an annual rate of 6.3% in the 4th quarter. Consumer spending took a double blow from a national sales tax increase from 8% to 10% and Typhoon Tagibis hit most of the country. Both occurred in October. Exports were also dented by the U.S. – China trade war. For the year, Japan's GDP declined 0.4%.

Additional concerns for 2020 include the coronavirus impact on their economy. Car parts shortages from China are already a reality. Japan will likely dip into recession this year.

China's GDP growth rate continues to slow. Q1 was 6.4%, Q2 was 6.2%, Q3 was 6.0%, and Q4 was 6.0%. Full year growth was 6.1%, their lowest reading in 29 years. Projections for 2020 recently ranged from 5.7% to 6.2%. Forecasts in the last two weeks, in light of the coronavirus, are being lowered further by 0.5% to 1%.

World: The IMF pegged worldwide GDP growth at 2.9% for 2019, 0.1% below their last forecast. Forecasts for 2020 range from 2.5% (World Bank) to 3.3% (IMF).

The impact of the U.S. – China trade negotiations was felt in business investment numbers as well as Institute of Supply Management readings for manufacturing and to a lesser extent, the services industry. Numbers above 50 mean growth. Service numbers have gone from the upper 50's late 2018 to a three-year low in August of 52.6. The service number rose back up to 54.7 in September and 54.9 by December. The January 2020 number was 55.5. The manufacturing sector had its first reading below 50 in August after averaging 56.5 over the previous 35 months. September and December readings were 47.8 and 47.2, respectively. The January 2020 reading climbed back over the 50 mark at 50.9. Let's hope this trend continues.

U.S. retail sales were up 4.1% for the year with a 0.3% increase in December. U.S. personal consumption for goods and services, which account for 67% of the U.S. economy, was up 4.14% at $14.8T from year end 2018. **The U.S. consumer is looking solid and is being supported by continuing strength in employment.** Initial claims for unemployment insurance remain at very low levels. This data points to continued growth in employment.

The headline rate of unemployment has been bouncing between 3.5% and 3.6% for five months. The participation rate is rising (age 25 to 54 participation rate is 83.1% vs a record reading of 84.6% in 1999), and the underemployment/unemployment rate is declining. Furthermore, the potential for gain in employment is in the range of about 2% to 3% of working age population. This is 1% lower than last year end. That means **more people are rejoining the workforce**. **Three out of four newly employed came from outside the workforce. This is a positive factor for continued GDP growth.** The hiring rate in 2018 was 223,000 per month. In 2019, it was 175,000 per month. The rate jumped to 211,000 per month in November, December, and January.

Wage and salary gains were up 4% in fourth quarter 2019 vs the year ago level.

At $1.3035T, total construction spending was down 0.3% from 2018. U.S. Industrial capacity utilization is at 77%. This is 2.8% below the long-term average. It is also about 4% below the level generally accepted as the point where there is no other option other than new investment. **This is a contributor to a lack of business investment growth in 2019.**

We have been stating that automotive sales and the housing market have very likely peaked. Automotive sales have been running in the 17 to 17.5 million range for the last three years and came in at 17.1 million vehicles in 2019. **But housing is another story. Mortgage rates are 1.3% lower than a year ago, housing starts were 1.608 million vs a forecast of 1.375 million. This is the highest reading since 2006 and a 48% jump since 2018 year end**. It is difficult to comprehend how this was possible given the land and labor shortages that have been chronicled. This number closely matches new household formation, something that hasn't happened since before the financial crisis. Existing home sales in December hit 5.54 million annual rate. This is up 10.8% from a year ago. The National Association of Realtors has the residential home supply at only 3 months at 2019 year end; a six-month supply is parity for buyers. Case-Shiller has home prices up 4.15% in 2019 through November. Expansion of supply needs to continue.

New risks on the horizon: Trade battle with Europe – Let's hope not, Europe needs to deal with completing arrangements with the U.K. and recover from the worst of the U.S. – China trade battle. **Coronavirus** – The risk of supply chain disruption from China is beginning to be a factor on many continents. Let's hope it can be contained and all get back on the road to recovery sooner rather than later.

Bottom lines

1. The U.S. consumer is strong.
2. Central bank policy around the globe remains loose, is not likely to change, and is imploring risk taking.
3. Brexit and the China trade battle took a turn for the better. There is more work to be done.
4. Growth stock valuations are very stretched. Loose FED policy is providing support for speculation.
5. Suppressed interest rates are helping the economy but would lead to limited protection in a stock market drawdown. Intermediate and long-term bonds are trading at high premiums to par, which would provide less counterbalancing to stock declines.
6. Europe's negative interest rates arguably are not helpful and difficult to exit.
7. Stock valuations are generally cheaper outside the U.S., but the menu isn't as enticing.
8. Excessive debt is problematic. When it comes to government debt, surprisingly, there is not universal acceptance of the foregoing statement.
9. To quote John Kenneth Galbraith, Economist (deceased), "There are two kinds of forecasters: those who don't know, and those who don't know they don't know." We remain focused on diversified, value oriented, and conservative portfolio construction with an eye for tactical adjustments.

Please feel free to contact us with any questions, or if you would like to schedule an in-person or phone meeting.

Thank you,

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