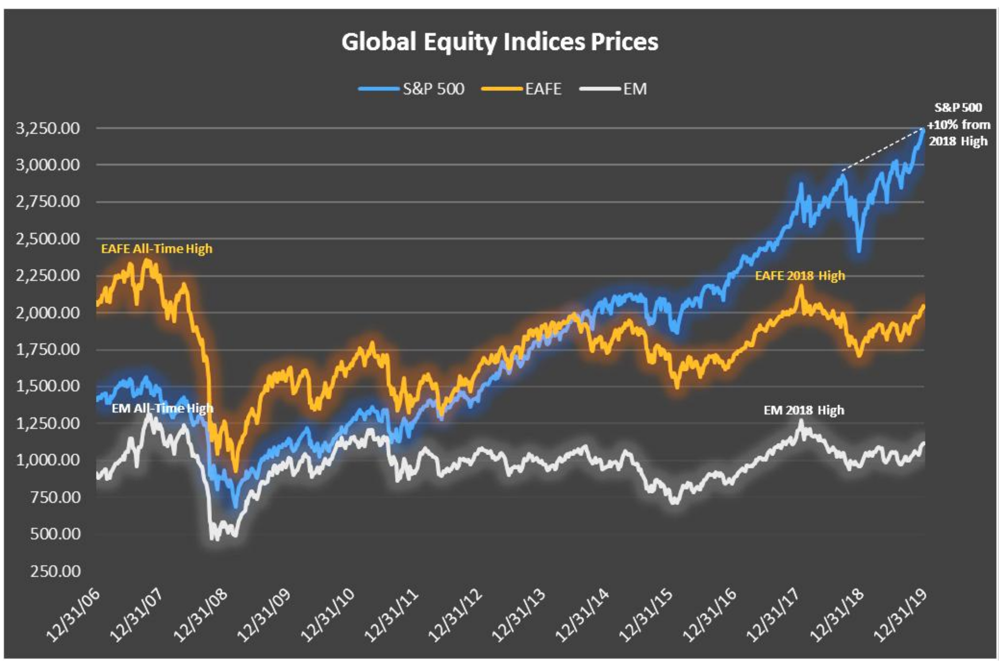
Market Review and Outlook

In what had already been a banner year for the markets, global stocks extended their year-to-date gains during the fourth quarter. The S&P 500 Index notched another impressive quarterly return of 9.1% (+31.5% YTD), closing the year near record highs. Encouragingly, the capital market strength proved broad based, as developed international equities (EAFE) posted a fourth quarter gain of 8.2% (+22.0% YTD) and emerging markets (EM) increased 11.8% (+18.4% YTD). Canada, India, Brazil, and Switzerland are just a few of the countries whose stock markets also hit all-time record highs in the quarter.

With the equity market expansion now headed into a record eleventh year, an obvious question is whether the strong double-digit market gains in 2019 may have caused stocks to become overextended. It's important to note, however, that 2019 equity returns were somewhat enhanced by the 20%-plus peak-to-trough selloff global equity markets experienced in late 2018. While domestic equities are near all-time highs, they are only 10% above the high reach in 2018. Moreover, international stocks in aggregate remain below their 2018 highs and their 2007 all-time highs.



Source: FactSet

Three factors are primarily responsible for driving U.S. equities to new highs in 2019. First, the Federal Reserve initiated three 25-basis-point rate cuts during the year, helping to offset fears of recession and trade war risks – further elongating the economic expansion cycle. Second, the U.S. consumer remained upbeat thanks to a 50-year low unemployment rate and steady wage growth. Finally, constructive signals pointing towards a trade resolution between the U.S. and China emerged as the year progressed, culminated by the "Phase One" trade deal announcement in December.

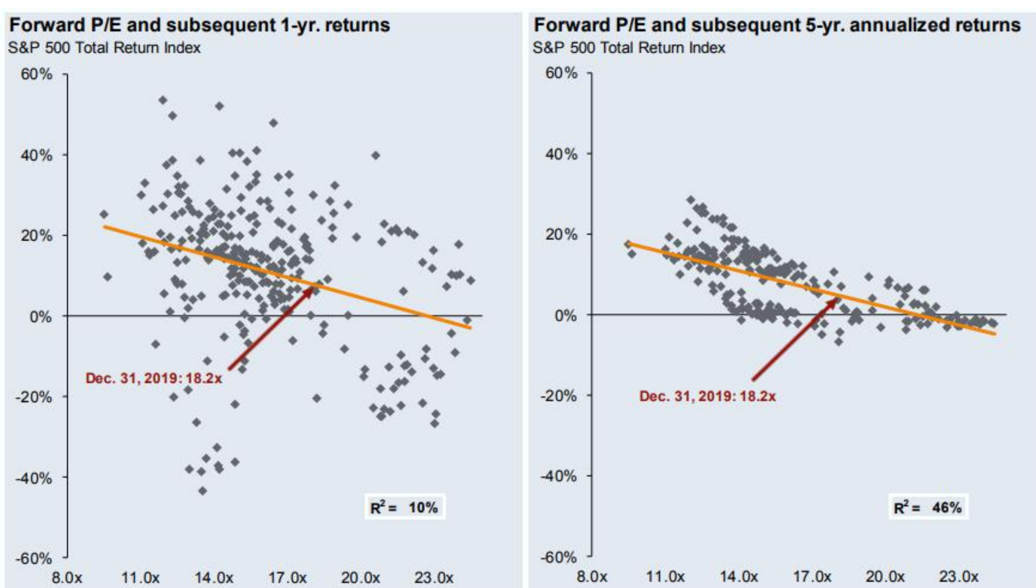
One conspicuous factor absent from the 2019 equity rally was earnings growth. S&P 500 earnings are expected to have increased just 1% during 2019, as trade tensions and slower economic growth weighed on sales during much of the year and rising labor costs cut into margins. Also, the torrid 22% earnings growth in 2018 (8% of which came from corporate tax cuts) set a high base for profits to grow off during 2019 – particularly this late in the expansion cycle. Current FactSet consensus estimates assume 2020 profit growth will reaccelerate to 10%. As is typical for year-ahead forecasts though, that projection could prove too optimistic. Still, mid-single digit EPS growth of 5-7% seems like a reasonable assumption if the economy continues to expand at a steady (albeit modest) pace this year.

Valuation is understandably another increasing point of concern for investors. In aggregate, valuation multiples for domestic equities are above average, as highlighted below.

Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	18.18x	16.26x	0.60
CAPE	Shiller's P/E	30.78	27.16	0.58
Div. Yield	Dividend yield	1.93%	2.09%	0.41
P/B	Price to book	3.32	2.96	0.49
P/CF	Price to cash flow	12.97	10.61	1.28
EY Spread	EY minus Baa yield	1.65%	-0.03%	-0.85

Source: FactSet, FRB, Robert Shiller, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management.

However, valuations are certainly not extreme in our view – particularly amid a backdrop of mild inflation, low interest rates, and reaccelerating earnings growth. Moreover, valuation metrics like forward P/E multiples haven't proven to be strong indicators of subsequent near-term (e.g., 1-year) returns. Over the longer periods (> 5 years) though, high P/E multiples are more strongly correlated with lower annualized returns.



Source: FactSet, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management.

Consequently, we don't think today's slightly elevated valuations signal an imminent market correction. That said, absent a material bounce in earnings growth, investors should expect more measured market returns in the future than they've grown accustomed to over the last several years when valuation multiples were generally more attractive.

This does not suggest equity exposure should be significantly reduced though. Even if the absolute prospective returns for U.S. equities are not as compelling as they were a few years ago, the relative attractiveness of stocks continues to eclipse that of other asset classes like bonds and cash. And as referenced earlier, equities outside the U.S. – as well as domestic small caps, value stocks, and resource-related companies – have not witnessed the same level of returns and valuation expansion the broad U.S. indices experienced. Thus, pockets of value can still be found in equities.

We plan to proceed in 2020 with a heightened level of caution, acknowledging that the late cycle market carries particular challenges for both the economy and risk assets. Nonetheless, we believe decent economic fundamentals, still reasonable valuations, and a favorable monetary policy backdrop can support further gains for equities. While we would not be surprised to see more erratic swings in market sentiment this year following the robust 2019 returns, we will use volatility (on both the upside and downside) to rebalance around our strategic long-term allocation targets.

Core Portfolio

It was a quiet quarter in terms of portfolio transaction activity, as we initiated no new positions during the fourth quarter and retained all of our prior equity holdings to benefit from the broad based market rally. Top performers for the quarter included Advanced Micro Devices (+58%) and Freeport-McMoran (+38%). The two worst-performers for the quarter were Constellation Brands (-8%) and CME Group (-3%).

We continue to be very constructive on our relatively high exposures to the Financial, Health Care, and Technology sectors, offering a compelling balance of growth and value. Although the market steadfastly marches on toward new highs, our analytical process continues to find new investment candidates that should offer appealing long-term growth potential once certain catalysts have been met.

Equity Income

Master Limited Partnerships (MLPs) posted a fourth quarter total return loss of 4.1%, reducing the full year return to +6.6% YTD. Despite the recent underperformance, midstream fundamentals have improved significantly. Free cash flows have been increasing and pipelines are using this cash to raise dividends and lower leverage. With MLPs yielding over 8.5% and trading more than 25% below their historic valuation levels, we believe it's only a matter of time before the attractive fundamentals of the midstream space are more fully appreciated (particularly relative to other overextended equity sub-sectors).

Fixed Income

The 10-year Treasury yield began 2019 at 2.7%, but dropped precipitously through the first three quarters of the year due to slowing global economic growth, continued U.S.-China trade tensions, rate cuts by the Fed, and falling sovereign bond yields throughout Europe and Japan. All those factors led to a brief yield curve inversion (2-yr Treasuries yielding more than 10-yr Treasuries) during the third quarter as the 10-year dipped below 1.5%. Encouragingly, the yield curve steepened throughout the fourth quarter as the 10-year yield stabilized and closed the year yielding 1.9%.

Long-term yields (and the yield curve) could continue to move higher in 2020 as global economic conditions improve and Treasury buying eases. That said, the gap between U.S. and international yields is likely to persist and global buying pressure will keep U.S. yields from moving appreciably higher. This trend could endure until growth and inflation pick up materially in Europe and Japan. Thus, we are likely to remain in a low rate environment for the foreseeable future – with a chance for rates to move even lower if the economy slips.

Final Thoughts

We thank you for your continued confidence and trust. As always, we welcome your comments and questions and look forward to our conversations in 2020.

May you have a very happy new year!

Parkside Investments, LLC

January 10, 2020

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