STEWART CAPITAL

Market Commentary – Fourth Quarter 2019

Malcolm Polley, CFA, President and Chief Investment Officer

Perfect Vision?

The end of a year... the end of a decade… While 2019 may have been many things, it was not boring. From more than twenty democratic candidates announcing and then running for their party's nomination for president in the 2020 election, to ongoing investigations into the President's actions, to the third Presidential impeachment since the founding of our republic, to hiking short-term interest rates and then an about face and cutting rates to forestall a possible recession, to markets providing rather dramatically higher returns than expected – 2019 was not boring.

While 2020 might seem to portend a year of perfect vision, it may well turn out that we are and have been a bit myopic.

Myopia – nearsightedness. Such is usually the downfall of market pundits and participants. We get so hung up on the recent past, specific data points or the potential of near term events that we fail to accurately put into context the information received and, as such, often reach faulty conclusions - to wit, the market's late 2018 and early 2019 obsession with inverted yield curves. As we have stated in past commentary, while it is true that an inverted yield curve tends to presage an economic downturn, it is nothing more than a reflection of the market's expectations of future interest rates. Indeed, subsequent to the late 2018 – early 2019 yield curve inversion, the Federal Reserve reduced short-term rates three times in the second half of 2019 and the yield curve resumed its more normal upward slope.

Why are the markets so concerned about the potential for a recession? Simply put, it is because the current expansion is the longest on record. As we have written in the past, market participants grow more concerned about a recessionary trigger the longer the expansion goes. While we know that economists have not figured out how to end the economic cycle of expansion and contraction, we are less concerned about the actual trigger and more interested in the economic landscape and how we can understand data points given proper (in our view) historic context.

As an example, personal consumption (including residential investment) has represented the largest portion of economic activity since data has been officially collected by the Bureau of Economic Analysis in 1929, ranging from a low of approximately 49% at the height of the Great Depression to a high of more than 83% in the early 1930s, and it has been running consistently above 68% since 1992. It should be no surprise, therefore, that as goes consumer spending so goes the economy. In general, once consumer spending slows, the economy slows and often dips into a recession. That does not mean, however, that a recession is a given if consumer spending slows. Indeed, consumer spending could be thought of as a coincident indicator (something that happens as a contraction or expansion is occurring) and, as such, has little predictive value in determining whether a recession will happen.

Then why write about it? Our point is that trying to understand or predict future economic activity from single data points or single economic statistics is a fool's errand. While it may be extremely profitable to correctly call tops and bottoms, in practice it is extremely difficult to do so with any degree of accuracy -

substantially reducing the profitability of those decisions.

In our mind it is far better to build a mosaic by using existing data in conjunction with historic information coupled with an understanding of demographics as well as how economic macro events impact decision making. This allows us to look at the range of economic and investment decisions offered and select those that provide the best risk and reward profile. In simpler terms, we can go into a situation well informed and with our eyes open. As a result, we have far fewer surprises.

The Economy

We have been discussing for some time the apparent link between the movement (in particular) of the Baby Boom generation (those born between 1946 and 1966) through time with economic growth. This becomes particularly visible to us if we look at GDP growth rates from 1930 through the end of 2018, (see chart below). What one will notice is that GDP growth trends higher from the end of WWII through the end of the 1970s. This data roughly coincides with birth of the Baby Boomers and their entrée into the labor force. The data displays a downward trend through the 1980's that coincides with the late Paul Volker's tenure as Chairman of the Federal Reserve, his restrictive monetary policies intended to bring inflation under control and the Boomers' impact on the growth rate of the working age population.

From 1990 through the end of the century we arrived at what we will call the Great Moderation – a period of relatively stable economic growth with (relatively) stable inflation. This Great Moderation also coincided with a renewed increase in the working age population growth rate which, once again, peaked at the turn of the century. It also overlaps with the Boomers' entering the age at which spending begins to moderate and peak (35 – 54 years old).

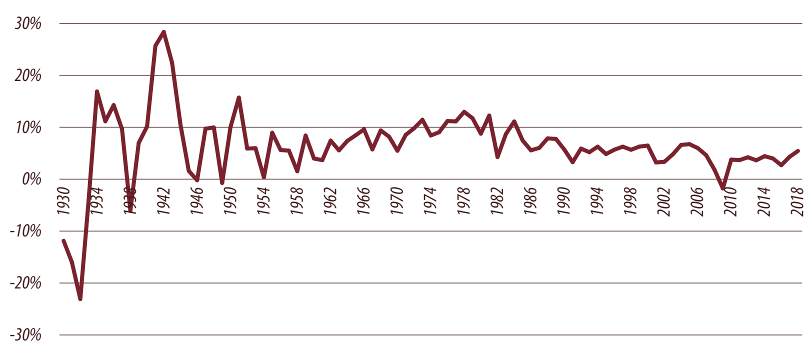
Let's fast forward to today… The working age population growth rate has declined continually since its most recent peak in 2000. This decline is expected to continue until at least 2030 as the Boomer generation exits the workforce. This decline in the working age population growth rate informs the inflation rate because an expanding working age growth rate means more people available to work, more potential earnings and more potential spending. It should not be a surprise, therefore, that inflation in the United States (which has a more favorable demographic makeup than any country within the developed world) and indeed the developed world and GDP growth have had difficulty getting to desired levels. We believe that current sub-optimal inflation and growth rates will continue for the foreseeable future, and that the domestic economy may well struggle to reach even the 3% growth seen during Q1 of 2019.

Interest Rates

If it turns out that Federal Reserve Chairman Powel was wrong, and the three rate cuts experienced during 2019 weren't just a "mid-cycle correction" (which we think is increasingly likely), then the 2.25-2.50% Fed Funds target range will turn out to have been the lowest peak Fed Funds rate in history and more than a full percentage point below the previous low peak of 3.47% set in 1957. Short-term interest rates are not just low, they are multi-generationally low and not expected to climb much across the globe.

The low rate environment is impacting rates across the credit spectrum with credit spreads at or near lows not previously seen by anyone currently involved with the markets and causing total returns to look more equity-like. But is it sustainable? Can we continue

GDP Growth Rate



Source: Bureau of Economic Analysis

to expect bond returns to achieve much above their current low coupon rates? In the words of a recent Bloomberg Professional column, "A number of Wall Street's most prominent credit analysts say 2019 will simply be too tough to beat."

Total return for any investment encompasses both income received and price movement (gains/losses). For a bond, the primary driver of price movement is a change in interest rates and for non-government bonds, changes in credit spreads (the difference in yield between similar maturity government and non-government bonds). With coupons on bonds ranging from less than 2% for most government bonds to less than 4.5% on investment grade bonds (according to recent characteristics of the Barclays Aggregate Bond Index from Bloomberg Professional) and a credit spread on the Barclays Aggregate at just 0.90%, there simply isn't much room for continued upward price movement.

Market Overview

To say that 2019 had returns that exceeded expectations is a massive understatement. Had someone predicted more than twenty-percent returns across equity markets in an environment where earnings growth expectations would falter because economic growth became suspect, they may well have been written off as delusional. In fact, the returns happened in large part because we ended up getting both nice double-digit growth in earnings as well as Price Earnings ratio expansion (due to lower rates) translating into increased equity values.

Outside of the tech-heavy NASDAQ, large cap shares shone most brightly. Unlike 2018, which saw equity markets collapse in the fourth quarter due to concerns about overly aggressive rate hikes from the Fed, markets moved noticeably higher in response to the Federal Reserve rate cuts and indications that the economy could well continue its expansion past 2020.

Fixed income returns, as indicated by market pundits above, were nicely positive, with higher returns coming, as should be the case, from longer dated and lower credit quality investments. Given the very low rate environment, much of bond returns over the past year came from price movement rather than coupon. While this is unusual, it is a relationship which we think will become more normal.

Outlook

Assuming the consumer continues to feel reasonably good about their station in life, they should continue to spend. This, in turn, should continue to drive the economy forward. Since jobs are plentiful (according to the most recent Job Openings and Labor Turnover Survey (JOLTS) data from the US Bureau of Labor Statistics, there are currently more than 1.4 million more jobs than unemployed people to fill them), the consumer should continue to be comfortable with their income prospects. This should continue to be the case even if layoffs and job cuts tick up - which we fully expect.

As we enter the "official" presidential election cycle with the kick-off of the Iowa Caucuses in early February, the risks of negative events, whether internal or external, will likely increase. As we saw both from the 2016 presidential cycle and recent elections globally, while international meddling may not determine an election's outcomes, it can have an unsettling effect on markets.

Potential geopolitical risks aside, we believe that 2020 could be a decent year for all but bond markets. Based on current consensus data from Bloomberg Professional, the market is expecting low teen growth in domestic index earnings and high single-digit growth from developed international market earnings. If we assume no P/E expansion and only modest contraction, we could see mid-single digit returns from domestic equities. International returns may be more in flux due to the addition of currency risks but, barring substantial upward movement in the dollar relative to global currencies, could see low to mid-single digit returns as well.

We are not expecting further changes in Fed Funds for 2020. As a result, government bond returns are not likely to be impacted by price movement and will largely reflect their coupon. Whether those returns are positive or negative will largely reflect the shape of the yield curve which is impacted by future expectations. Non-government bond returns will also likely consist largely of coupon clipping and have little impact from rate movements. However, if spreads continue to tighten, a scenario we see as increasingly unlikely, non-government bonds could get a bit of a goose in returns. That said, the most likely scenario for bond returns is to see slightly negative to modestly positive (low, single-digit) returns giving cash the best risk/return profile when compared to fixed income assets.

Strategy Overview

Now that interest rates seem to have peaked, and as we near the end of the economic cycle, keeping a close eye on the relationship between risk and return becomes increasingly important. Gauging appropriate valuation and purchase prices relative to risks has always been and will always be our primary focus. Linking investment decisions to something tangible like the cash generating capabilities of a business or investment and assigning a minimum acceptable rate of return to each decision should add value. Elevated risks should translate into higher return requirements and lower valuations all else equal.

Looking at investments as would any rational person helps us focus on those things that are important: return of and return on capital invested.

Regardless of the environment or level of market uncertainty, when we see investment opportunities that allow us to earn returns in excess of our requirements, we jump. Over time, this should allow us to be well compensated for the decisions made. In our mind, the real risks are those not taken.

Stewart Capital Advisors, LLC • 800 Philadelphia Street • Indiana, PA 15701 • 855.783.9227