Argent
Wealth Management, LLC

Investment Outlook

Winter 2019

Fourth Quarter 2019 Review; First Quarter 2020 Outlook

What a Quarter & Year! What to Expect in 2020

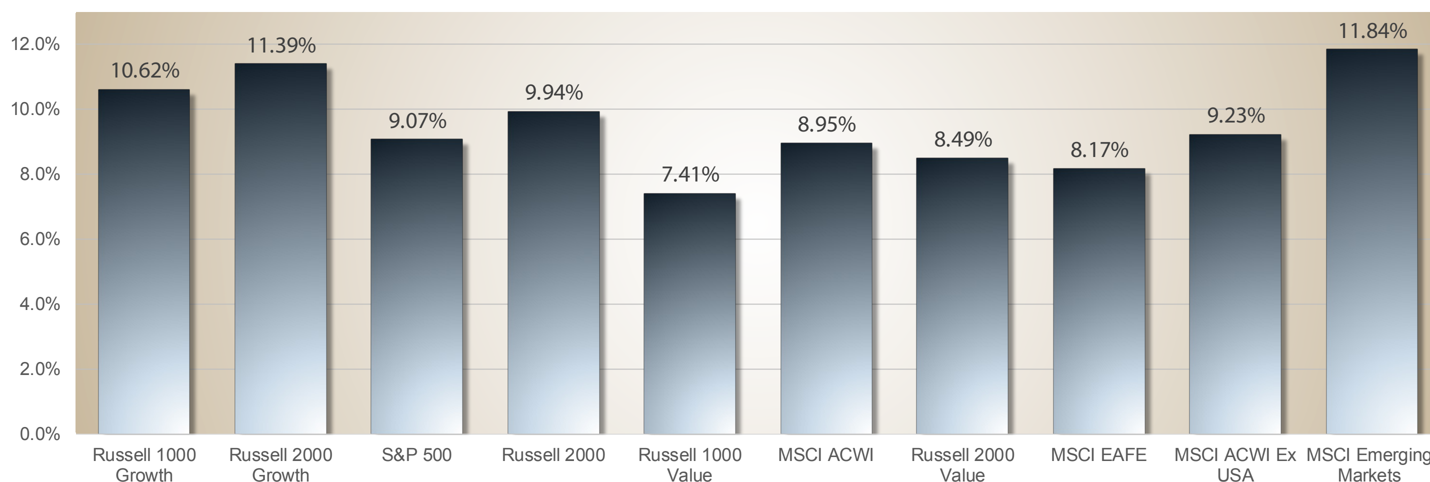
Despite geopolitical uncertainty surrounding BREXIT, trade disputes and a potential impeachment, equity markets posted broad and strong gains in the fourth quarter. This is due to stabilization and even upward surprise readings of previously negatively trending economic data. The yield curve, which was inverted at key levels for most of the year, steepened. When the bond market shifts from inverted to upward sloping, it no longer portends a continuation of negative economic trends. The U.S., which has been more resilient economically than the rest of the world over the past few years, continued to outperform international markets. After 2 years of underperformance, small cap stocks finally outperformed large cap stocks in the fourth quarter. Cyclical sectors outperformed more defensive sectors, which usually means the equity market is forecasting more positive economic data in the future.

With yields rising in the fourth quarter, bond returns were muted. High yield and bank loans outperformed investment grade and government bonds, aligning with the risk-on equity market message. Despite these various risk-on signals, most markets around the world are still off their peaks reached in January 2018. When positioning portfolios for what might happen in 2020, it is useful to revisit the patterns and trends we have seen during the up and down market of the past two years.

Macro Market Review

Largely due to the substantial correction in the fourth quarter of 2018, broad global and U.S. equity indices were generally negative in 2018. Bond returns were slightly positive or negative. Interestingly, most economic data during that time was strong. For example, PMI readings (Purchasing Manager Index, one of the more accurate forward indicators) showed 70% of world economies expanding. Earnings in 2018 were up over 20%. With strong earnings growth and economic data, why did equity markets correct?

Equity Performance 4Q'19



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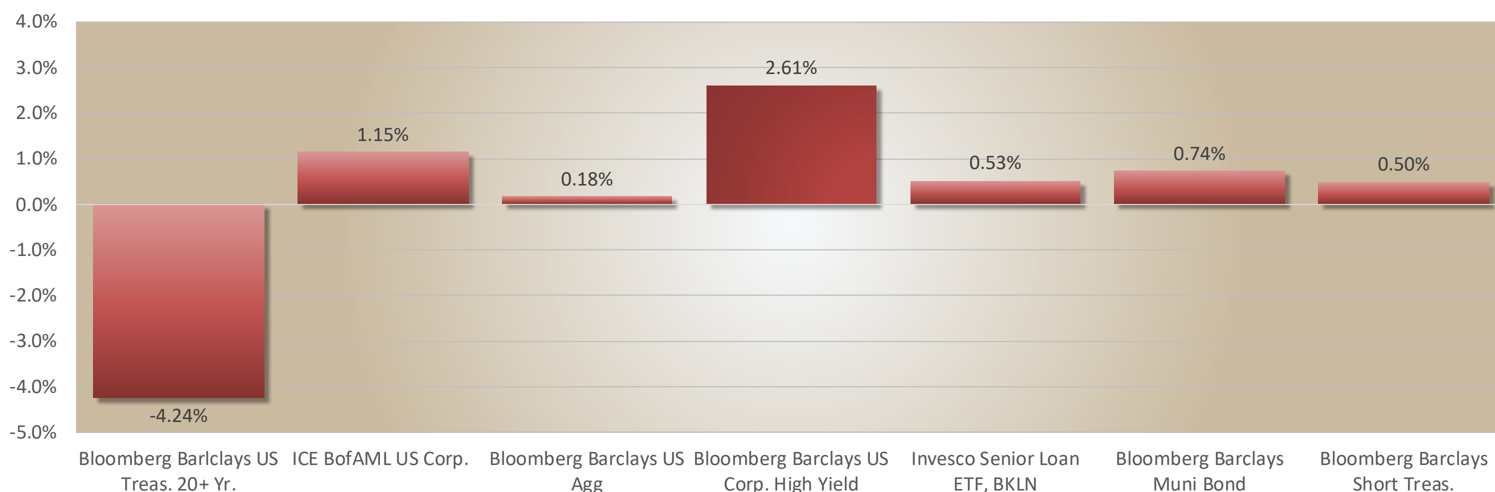
Fixed Income Performance 4Q'19



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Unlike 2018, 2019 has been one of the best years in the history of equity markets. Bond returns were strong too. The technology sector was up almost 50%! Financials gained 32%. The S&P 500 returned 31.5%, and the world stock market (MSCI All Cap World Index-ACWI) was up 26.6%.

These returns came on the heels of negatively trending economic data. By the end of 2019 only 40% of global PMI readings indicated expansion. Earnings are expected to be almost flat. With this backdrop, it is no wonder that investors flocked to bonds throughout the year. Investors that took on the most interest rate risk were rewarded with strong returns until yields fell in the fourth quarter as evidenced by the Bloomberg Barclays US Treasury 20+ Year Index. That Index returned 20.2% through 9/30/19 and then dropped 4.2% in the fourth quarter. The question is, with weak earnings growth and weakening economic data, why did equity markets do so well?

Equity Markets are the Ultimate Forward Indicator

With the yield curve inverted for most of the year many investors felt that the negatively trending economic data would likely continue. However, equity markets stayed resilient all year, indicating that the economic data was likely to stabilize and rebound.

Equity markets tend to move ahead of economic data. In the fourth quarter of 2018 equity market observers predicted tightening by the U.S. Federal Reserve and

ACWI (All Cap World Index) ETF

Source: Factset: Argent Wealth Management, LLC © 2020

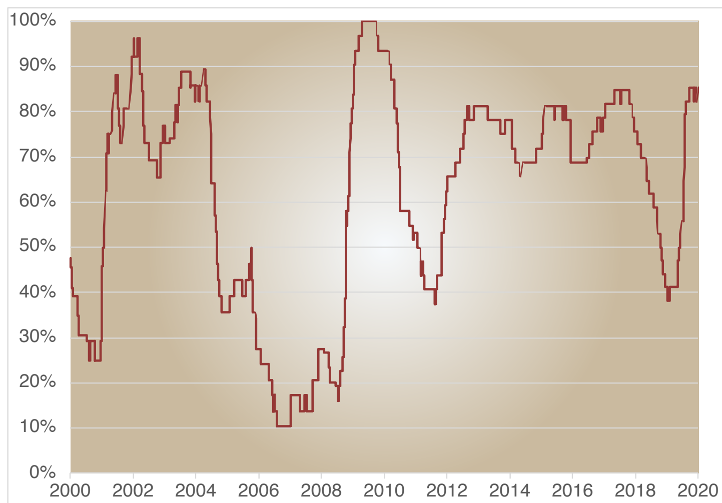
other central banks around the world, when combined with uncertainty around U.S. trade negotiations and other political factors, would cause economic data to trend negatively. The market reacted ahead of economic data that ultimately trended negatively.

In 2018 domestic and foreign central banks were generally sending a hawkish message to the market. In the fourth quarter equity markets reacted to this message and corrected significantly. The Fed took that as a signal that they tightened monetary policy too much.

Not long after the equity markets corrected, the Fed started to signal a more dovish message. Picking up on this message, the domestic stock market rebounded strongly. Throughout 2019 most major central banks lowered rates. By the end of 2019 over 85% of central banks around the world were lowering rates. According to Ned Davis Research (NDR) going back to July 1989, typically equity markets gain 8.25% per annum when over 50% of central banks ease rates. With over 80% of central banks easing by the end of the year, it isn't a huge surprise that the ACWI rose 26.6% in 2019.

Looking at calendar year returns in isolation can be deceiving. Most markets around the world peaked in January 2018 and either did not or barely exceeded that peak in 2019. Therefore, for the past two years we have been in a difficult market environment.

Percent of World Central Banks Where Last Rate Change was a Decrease



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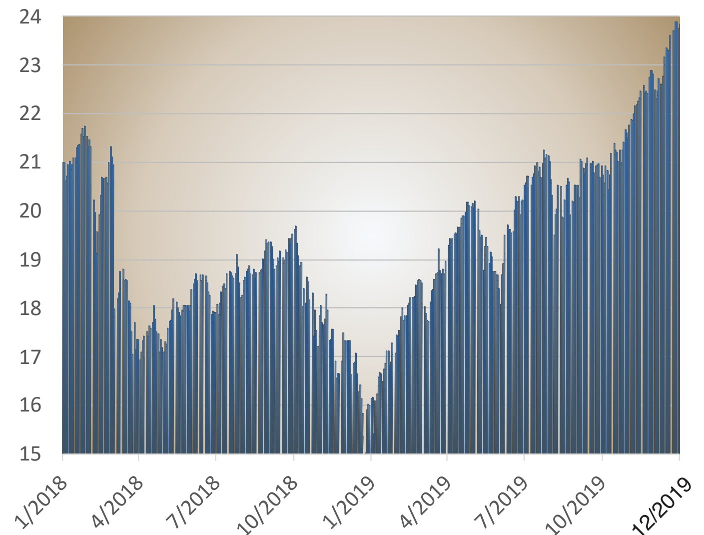
Micro Market Review

Over the past two years large cap stocks have outperformed small cap stocks. Now the top 40 stocks in the ACWI account for almost 30% of the market capitalization of all world stocks, the highest reading in over 10 years. A lot of this is driven by the performance of large technology stocks. Tech stock valuations are at their highest level in two years, and this calls into question whether the rally in large tech stocks that has helped to fuel the returns of global markets in 2019 is sustainable.

U.S. Technology Stock Forward Price-to-Earnings



Source: Factset, based on FTEC ETF

"Tech is about 20% of the S&P 500, 7% of Foreign Developed markets and 13% of U.S. Small Cap indices, which helps to explain why U.S. Large Cap has returned significantly more in the past year than most markets around the world."

International markets are still about 9 percentage points from their all-time high reached in January 2018, and small cap stocks are still about 5 percentage points from their all-time high reached in August of 2018. Most stocks around the world are still below peaks reached in 2018! The S&P 500 is at an all-time high, in large part due to a higher concentration of large stocks in the top performing technology sector. This helped fuel a new high in the ACWI as the U.S. makes up close to 60% of world market capitalization.

What to Expect in 2020

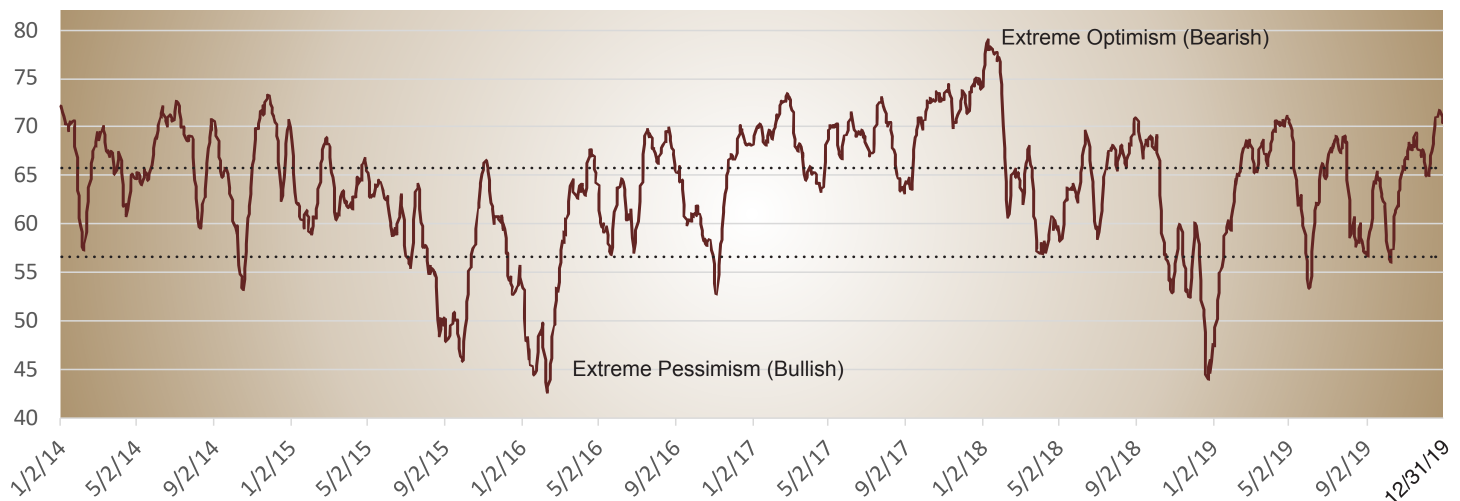
It is more likely the market will end the year positive than negative, but investors should expect returns in the single digits. Market dips should present opportunities to add risk at lower prices. There are more signs than not that economic data has bottomed and is set to rebound in 2020. This comes on the heels of global central bank accommodation. Looking at 2018 and 2019, rebounding economic data does not foretell strong equity market returns. For most of 2019 equity markets predicted that central bank accommodation would reverse negatively trending economic data and we would avoid a recession, so this is priced in. The Fed is now on hold for the foreseeable future, so that tailwind will slowly abate. Earnings growth is expected to increase again in 2020, but equity markets have this priced in. Valuations, while on the high side, are within normal ranges. While valuation is an important fundamental input to decision making, it tends to be a poor predicter of year-to-year performance. NDR's Crowd Sentiment Poll indicates that most investors are optimistic about the market. Going back to 1995, on average, when this poll signals optimism the market has gone down 2.6% per annum; when this poll signals pessimism, the market has gone up 11.22% per annum. Geopolitical uncertainty remains high. For all the above reasons, it makes sense to enter 2020 with some caution. However, with economic data set to recover, investors should refrain from taking too bearish a stance.

In these types of markets, it is important to take advantage of volatile periods and pay attention to sector by sector and country by country fundamentals and opportunities to make appropriate portfolio tilts. Currently, investors should pay close attention to trends and fundamentals within small cap and international markets. These areas have underperformed large cap U.S. over the last two years and valuations are more compelling. The dollar strengthened in 2019, but this trend has moderated, and fundamentals point to a potential reversal. This would help U.S. investors' investments in foreign markets.

Dividend Growth continues to be a sweet spot for investors. These stocks tend to outperform over very long periods of time and to exhibit good down-market capture and less volatility. A holding we like in this sector is DGRO (iShares Core Dividend Growth ETF), which was up 30% in 2019.

Investors should pay close attention to their long-term goals and stay within an appropriate level of risk to achieve those goals. Caution makes sense going into 2020, but it will be important to make appropriate tilts as markets present opportunities for investors that are ready to seize them.

Ned Davis Research Crowd Sentiment Poll



Source: Ned Davis Research

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