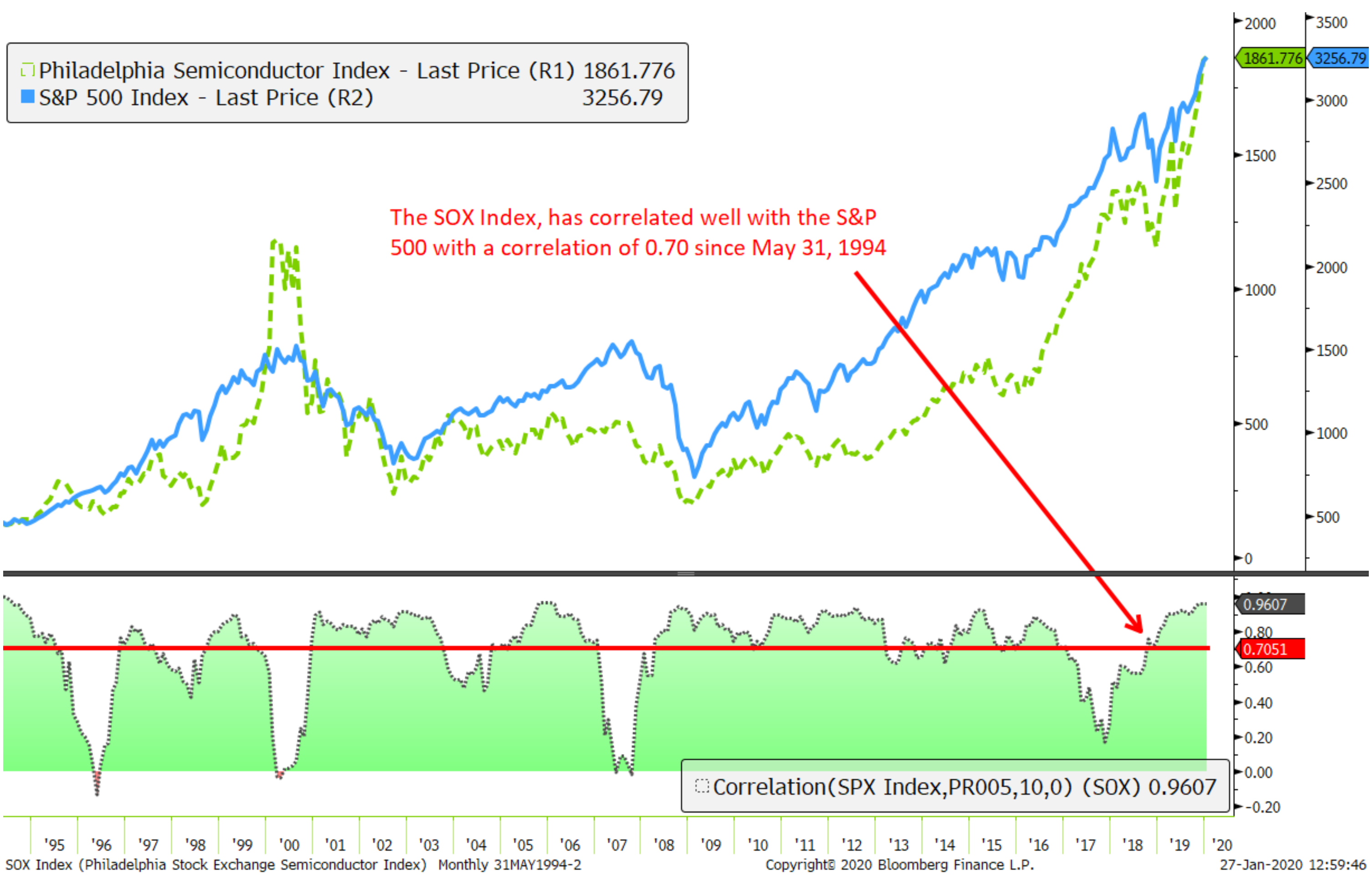
2019 Fourth Quarter Review

January 28, 2020

"Everything is changing. People are taking comedians seriously and the politicians as a joke." – Will Rogers

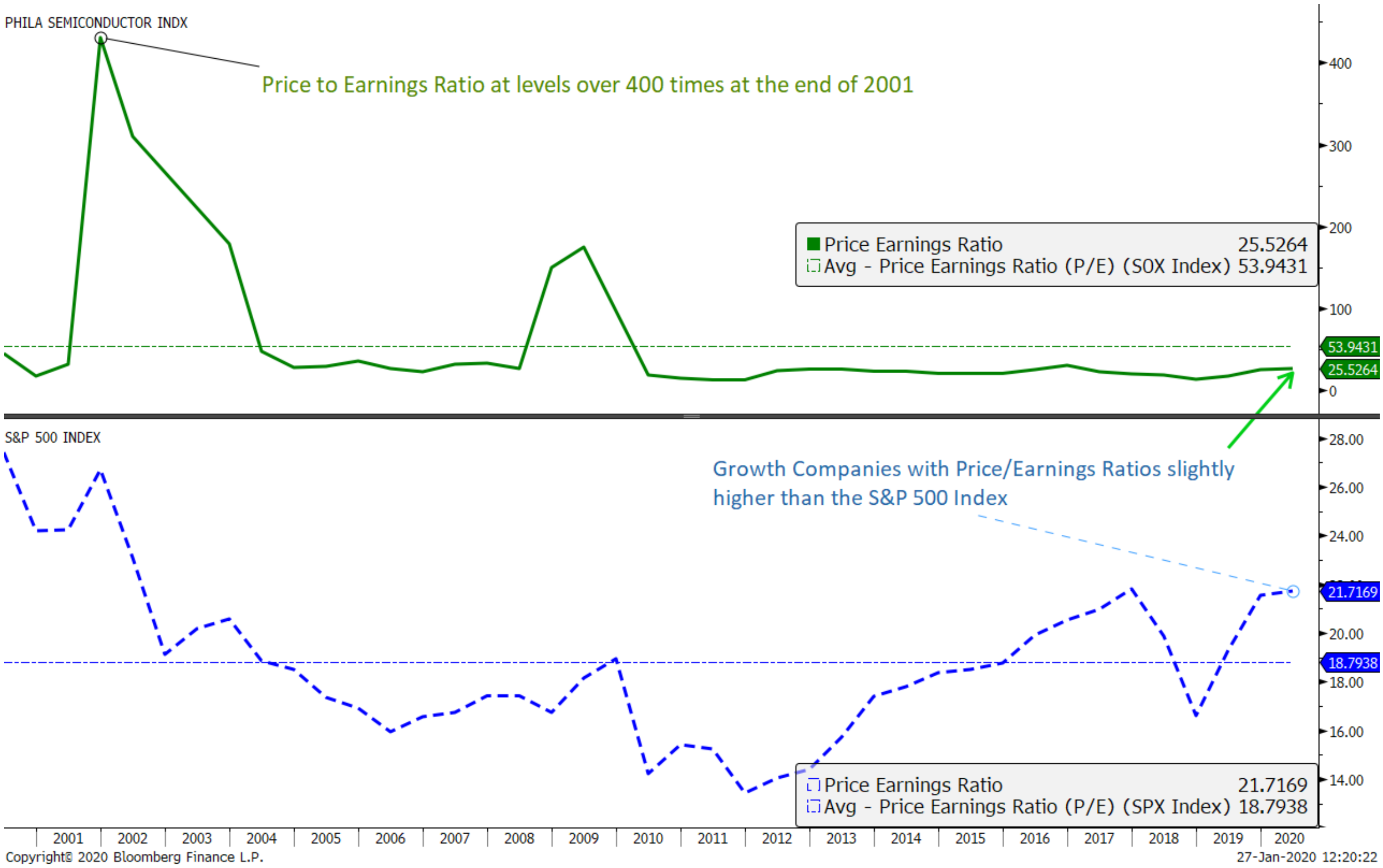
What a great year 2019 was for the U.S financial markets! No one at the start of 2019, us included, forecasted that it would end so well. The S&P 500 advanced 31.5% (including the reinvestment of dividends), the best year since 2013 when the return was 32.4%. Not only did equities perform fabulously, but bonds had a great year too! When measured by the iShares Core U.S. Aggregate (AGG) ETF, the general bond index returned 8.5%. The only asset class to lose last year was commodities which was down -6.0%.

Since early January, we generally leaned into our equity allocation for our portfolios after the 20% selloff in the 4th quarter of 2018. We accepted the risk of the equity markets in spite of the numerous business and geopolitical issues we documented last year. In addition, we fortunately ignored many of the indicators that have worked in the past that rely on industrial activity. According to a recent Bloomberg article, *"Manufacturing now makes up just 11% of gross domestic product in the U. S, the smallest share since 1947."* We have observed that the U.S economy is becoming more of a service economy with the rising importance of intangible assets and technological advances. In 2019, 25% of the S&P 500's return came from just five companies: Apple, Microsoft, Alphabet, Facebook and Amazon. We have come



a long way from when the CEO of General Motors made the following statement to Congress in 1953 *"As goes GM, so goes the Nation."* By the way, Tesla now has a market cap 2x greater than GM. Hard to believe.

Instead of looking solely at industrial activity, we have looked at other indicators for changes in our economy. One such indicator, the Philadelphia Semiconductor Index (SOX) has correlated well with the S&P 500 with a 0.70 correlation as the chart above demonstrates. Unlike the 1990's stock market run-up, the companies mentioned above are not new startups with high IPO valuations but mature companies that touch our lives every day and that are growth companies with price/earnings ratios slightly higher than the S&P 500. In the chart below, annual P/E ratios are plotted since 2000 with the SOX and S&P 500 indices at current levels of 25.5 and 21.7, respectively.



As we have stated before, we remain cautiously optimistic. As we write this after MLK day, President Trump's impeachment trial has begun in earnest before the U.S Senate. Obviously, 2020 will be unlike any other with geopolitical risk our primary concern. The U.S. economy has done well for a number of years: in fact, the expansion has been the best since before the War Between the States.

We would be surprised if the bond market has a repeat of 2019. 10-year bond yields are near the lowest level since 1960 (60 years) and are not expected to change much over the foreseeable future. Once again we find ourselves with few places to hide until the uncertainty fades, but that's what makes a market.