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WEALTH MANAGEMENT

<u>4th Quarter 2019 Investment Letter</u> by Erik Ridgley, CFA   January 31, 2020

We want to wish all our clients & friends a wonderful Winter, plus provide a review of the markets in the 4th Quarter of 2019 and our thoughts about 2020. We're pleased to report our firm's 2019 investment returns: Tax-Exempt Municipal Bonds +7.85%, Global Equities +27.40%, Large Cap US Equities +31.53%. We continue to invest for the long-term per each client's custom investment policy statement.

Asset Class Benchmark Index Returns – 4th Quarter 2019 (4Q19) and Year-to-Date (YTD)

4Q19: +8.95%	YTD: +26.60%	Global Equities: MSCI All Country World Index (ACWI)
4Q19: +0.74%	YTD: +7.54%	Municipal Bonds: Bloomberg Barclays Muni Bond Index
4Q19: +4.84%	YTD: +17.07%	50/50 Blend Portfolio: 50% ACWI / 50% Muni Bond
4Q19: +9.07%	YTD: +31.49%	U.S. Large Cap Equities: S&P 500 Index
4Q19: +9.94%	YTD: +25.52%	U.S. Small Cap Equities: Russell 2000 Index
4Q19: +8.17%	YTD: +22.01%	Foreign Developed Equities: MSCI EAFE Index (EAFE)
4Q19: +11.84%	YTD: +18.42%	Emerging Markets Equities: MSCI Emerging Markets Index
4Q19: -0.80%	YTD: +24.45%	Real Estate: S&P U.S. REIT Index
4Q19: +2.61%	YTD: +14.32%	Junk Bonds: U.S. Aggregate Corporate High Yield Index
4Q19: +0.18%	YTD: +8.72%	U.S. Fixed Income: U.S. Aggregate Bond Index (AGG)

US Federal Reserve Board ("the Fed") Wants to Sustain this US Economic Expansion

Ever since the Great Financial Crisis of 2008, the Fed's greatest fear has been deflation, and the most likely catalyst for deflation is a recession. There's more to the story, of course, but 2019 was a vivid reminder of why experienced investors respect an old saying in the stock markets, "Don't fight the Fed." The Fed implemented its third 0.25% rate cut of 2019 on Oct 30th. The yield curve is indicating that the next and last rate cut for this easing cycle will occur in the second half of 2020. The Fed also implemented significant increases to its balance sheet to address "plumbing issues" in the overnight repo markets, but it took great pains to deny that this was their fourth campaign of quantitative easing (QE 4).

Based upon ample empirical evidence that the central banks in Japan, Europe and U.S. have been unable to raise inflation up to their preferred targets, the Fed has become more concerned with fighting deflation/disinflation than inflation. Simply put, the Fed knows how to defeat inflation, but they don't know how to defeat deflation, and so now deflation is the more dangerous foe. To be fair, former Fed Chairman Ben Bernanke successfully overcame severe disinflationary forces unleashed during the Great Financial Crisis of 2008 with inflationary monetary policies such as extraordinary asset purchase programs (APP) and aggressive quantitative easing (QE). In a panel discussion on 1/4/2019, former Fed Chair Janet Yellen said the Fed would use APP and QE again during the next recession, after lowering the Fed funds target rate to zero (but not negative). She is to be believed.

The Fed has enormous influence over the supply of liquidity (i.e. money) in the markets and, of course, controls the Fed funds target rate. The Fed's decision-making process is focused on interpreting reported economic data, whereas investors and lenders try to anticipate future economic activity. This is normal, and it is why the Fed is naturally "behind the curve." In fact, the Fed generally takes its cues from the Treasury bond markets, rather than the other way around. Important exceptions to this rule can occur, in which cases it will often be said that the markets believe the Fed is committing a "policy error," for example by raising rates when it should be cutting rates. Markets react very negatively to policy errors.

Negative Interest Rates: Over Five Years of a "Policy Error" by the European Central Bank

Across the pond, Christine Lagarde has replaced Mario Draghi as President of the European Central Bank (ECB), which is the most important job in Europe. Draghi will be best remembered for his promise that the ECB would do "whatever it takes to preserve the Euro" in a speech on July 26, 2012 during the depths of the European sovereign debt crisis. As an Italian economist, trained in America at M.I.T. alongside Ben Bernanke, he led the ECB, a vital international institution historically dominated by a vocal German constituency arguing for austerity, through eight years of aggressively loose monetary policy. It wasn't easy (no pun intended).

History will not look kindly upon Draghi's controversial decision to lead the ECB into negative interest rates policy (NIRP) in 2014, and then leave it there indefinitely, which by my criteria meets the definition of a significant and ongoing central banking "policy error", because it has negatively impacted the profitability and lending capacity of many banks and financial institutions in Europe, for whom the ECB should be their patron saint.

There are $14 trillion of bonds with negative interest rates across Europe and Japan. Lagarde is expected to continue the dovish (i.e. lower interest rates) monetary policies of her predecessor. Her greatest challenge will be extricating Europe from NIRP during her term without causing undue harm to the economy nor the ECB itself.

China's Deceleration Continues and Why It Matters

China's "novel coronavirus" is causing terrible human suffering, but historical experience tells us that the authorities will contain its spread. It will dent the economy in the first quarter, but it won't have a meaningful long-term investment impact. Less well known is that over 3 million fewer cars were sold in China in 2019 vs. 2017, which is similar to the net decline that occurred globally during the 2008 Great Financial Crisis. As such, China was "patient zero" for the global manufacturing contraction of 2019, but the primary cause (controlling the excessive debt to GDP in China) of this economic malaise will be a competing priority for policymakers for the foreseeable future.

China's economy, the world's second largest after the U.S., continued to decelerate in response to nearly two years of government-imposed crackdowns on "shadow bank" lending, which violated the *Law of Unintended Consequences* and created a capital crunch for small/medium private businesses in China.

Also, the increasing likelihood of semi-permanent 7% to 25% tariffs on many exports to the U.S., amid doubts that a so-called phase 2 trade deal can be negotiated and enforced, has been a catalyst for western supply chain managers (e.g. Wal*Mart, etc.) to re-locate manufacturing sources from China to other countries in southeast Asia, Taiwan (e.g. Foxconn/Apple) and Mexico. This new supply chain trend appears to be gaining momentum across corporate America, and it will reshape global trade flows for many years.

In order to maintain their targeted 6% GDP growth rate in the face of these headwinds, the Chinese government authorized significant fiscal and monetary stimulus in July 2018. Given the typical 6 to12 month time lag for stimulus to take effect, the green shoots of stabilization have been sprouting in economic reports from China. However, according to Ted Orlik, chief economist at Bloomberg Economics with a decade in Beijing, "The legacy of past stimulus – bank assets about 300% of GDP – means space for another credit splurge is limited." Monetary and fiscal policies implemented by the Communist Party are big enough to significantly change price levels across global markets (whether Adam Smith likes it or not).

<u>Review of Markets in 4th Quarter 2019: Looking Past the EPS Recession of 2H19</u>

The S&P 500 index of stocks gained from 2,977 to 3,231. 10-year Treasury yields rose from 1.67% to 1.92% (thus the price of bonds fell). West Texas Intermediate (WTI) crude oil prices per barrel rose steadily from $54 to $61. The US dollar currency index weakened from 99.39 to 96.39. U.S. unemployment rates remained at record breaking low levels of 3.5%. And yet, as good as investment returns were throughout the quarter and the year, global economic data and companies' earnings per share (EPS) were persistently weakening. In fact, EPS growth in both 3Q19 and 4Q19 was negative, so we just experienced an EPS recession (albeit a mild one) for the first time since the second half of 2015.

The world's major economies decelerated in the 4th Quarter. The U.S. economy grew 1.7% in the fourth quarter according to the Atlanta Fed's "GDP Now" forecast, which is closely followed by professional investors. Europe's economy decelerated to 0.1% growth, well below its trend rate of 1% growth, and Japan's economy decelerated towards its trend rate of 0.5% growth. Low unemployment rates around the developed world (4% in Germany, for example) speak mostly to the growth of global service sectors, which now dwarf the more cyclical global manufacturing sectors (which were contracting in 2019).

Capital markets are finally imposing financial discipline on profligate shale oil frackers. Low oil prices are good for consumers, but too low oil prices are bad for producers. Advances in the revolutionary technologies of hydraulic fracturing and horizontal drilling have made the U.S. a top three oil producer along with Saudi Arabia and Russia. Since neither Russia nor the U.S. are members of the OPEC cartel, global oil production levels are now subject to various new and untested regimes of short-cycle shale drilling economics, informal agreements between geopolitical adversaries, and sanctions enforcement actions (e.g. on Iran and Venezuela). Oil demand is more straightforward; it is simply a function of global economic activity. Stock markets of producing countries have historically been closely correlated with oil prices, and now this is increasingly so for the U.S. (which became a net exporter of oil in 2018).

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<u>**Outlook for Markets in 2020: Soft Landing for the US Economy**</u>

The U.S. economy will re-accelerate to +2.7% growth in the first quarter of 2020 according to the Atlanta Fed's "GDP Now" initial forecast, but it seems likely that Boeing's delayed shipments of its 737-Max airplanes and China's coronavirus quarantines (of over 50 million people) will cause this forecast to be revised down.

U.S. operating earnings per share (EPS) growth clocked in at over +20% for each quarter of 2018, but 1st Quarter 2019 (1Q19) EPS dropped to +2.8%, +0.8% for 2Q19, -1.2% for 3Q19 (actual), -1.4% for 4Q19 (estimate), and +1.2% for Fiscal Year 2019 (FY19); +3.0% for 1Q20, +6.0% for 2Q20, +9.6% for 3Q20, +14.5% for 4Q20, and +8.6% for FY20, per I/B/E/S data by Refinitiv. The stock market narrative for now is that 4th Quarter 2019 will turn out to be the low point for EPS growth rates, in part because central banks will pilot a "soft landing" with "insurance" rate cuts. Guidance pronouncements from managements of companies that are reporting 4th Quarter earnings will be one of the keys to whether this narrative holds up.

Price/earnings (P/E) multiples are 18.3, 14.5, and 12.3 for U.S., foreign developed, and emerging markets, respectively, where E is EPS for the next four quarters. The long-term average for U.S. P/E multiples is 15 ½. Thus, equity valuations are 18% above average, although most researchers would say that the lower interest rates we have today (and those forecasted for the future) should allow for higher P/E multiples, all else being equal. The counter-argument to this would be that lower U.S. Treasury bond yields are signaling lower future GDP growth, which should dampen future EPS growth.

The yield curve is currently pricing in one 0.25% Fed rate cut this year (90% probability per Bloomberg WIRP), and 10-year Treasury yields of 1.6% at year-end 2020 (per Bloomberg FWCM). The Treasury yield curve represents the "real money" pricing of many trillions of dollars of U.S. Treasury securities across maturities from 7 days to 30 years, based on bond investors' expectations for the future, which is why it commands the respect of equity investors and the Fed. Of course, the yield curve always reserves the right to change its mind.

Inverted yield curves are seen to be reliable predictors of recessions, but the yield curve is not inverted now. The yield curve was "officially" inverted for one week in late August 2019, when 10-year Treasury yields fell below 2-year Treasury yields by a few basis points (-0.03%). However, there are many other "unofficial" definitions of an inverted yield curve, for example 10-year yields were materially lower than 3-month yields for five months from May to September in 2019, and this differential has just dropped to zero due to coronavirus fears.

High yield bond spreads (over Treasuries) remain tight, indicating credit markets are calm.

The highly respected UCLA Anderson Economic Forecast is predicting the U.S. economy has decelerated to its trend rate of growth of +2.1% GDP in 2019, and then will decelerate further to growth of +1.7% GDP in 2020, before rebounding to +1.9% growth in 2021. Most Wall Street forecasts are predicting U.S. GDP growth of 1.5%-2% in 2019, with almost none predicting recession in 2020.

Although the U.S. economy has not experienced a GDP recession for over ten years, the US suffered EPS recessions in the second half of 2015 and the second half of 2019.

US business cycles die from the Fed raising the Fed funds target rate too high for too long, rather than from old age. Inflation has remained below the Fed's target of +2.0% for many years, and the Fed has indicated it is willing to allow inflation to rise above its target level "for a sustained period" before feeling compelled to react with additional rate hikes. Markets will be focused on whether the Fed can pilot a "soft landing" for the U.S. economy in 2020.

Long-Term Investing

As Warren Buffett says, successful investors need to invest for the long-term and avoid being swayed by the fear and greed of others that can cause irrational swings in the market. We do not let the daily noise and volatility of the markets deter us from our mission to be faithful stewards of our clients' capital. As long-term investors, we and our clients have committed ourselves to adhere to well-defined investment policy statements, which have been custom-built for each individual client, in order to achieve their long-term investment objectives, while accepting the inevitable price fluctuations of the public markets. As fiduciaries, we relentlessly seek out the lowest costs and best terms for our clients. As trusted advisors, long-term relationships are of primary importance to helping our clients achieve successful outcomes through personalized planning and disciplined implementation.

Consistent & Predictable Processes: Portfolio Rebalancing, Tax Loss Harvesting, Tax Deferral

Portfolio rebalancing is a useful tool for long-term investors because it serves two important purposes. First and foremost, it keeps asset allocations in line with targets that have been codified in clients' investment policy statements. Second, it can be a mechanism to naturally "buy low, sell high", because it involves adding to an asset class that has decreased in price (e.g. >10%) relative to the overall portfolio, and cutting back an asset class that has increased in price relative to the overall portfolio. Good judgment, disciplined decision-making, and operational excellence are necessary to obtain the best results for every client from portfolio rebalancing.

Another proven methodology for long-term investors to take advantage of market volatility is tax loss harvesting. Unlike tax loss selling, tax loss harvesting precludes adverse impacts to investment returns, by simultaneously replacing the sold securities with very similar securities, while avoiding IRS wash sale rule violations. We actively implement tax loss harvesting throughout the year whenever material market declines create opportunities.

Tax losses provide economic value because they can be used to offset capital gains tax, and unused tax losses can be carried forward into future years until they are fully used. The maximum federal tax rate on short-term capital gains is 40.8%, including the 3.8% net investment income tax, and for Californians the maximum combined state and federal tax rate is 54.1%. Although no one likes down markets, tax loss harvesting can effectively reduce negative returns by up to 54.1%, without sacrificing full participation in the inevitable market recovery for long-term investors.

Tax deferral strategies involve delay or even avoidance of realization of capital gains through judicious planning, risk management techniques, and a commitment to long-term investing. Some unrealized capital gains can be permanently eliminated over time with proper planning via step up in cost basis.

Conclusion

To summarize: Concerns amongst investors about economic data signaling decelerating global growth have eased, and the treasury bond markets, credit markets, and equity markets all seem to have coalesced around a baseline forecast that the world's major central banks can pilot an elongated "soft landing" for the economy (i.e. GDP growth rates fall but stay above zero) with synchronized monetary easing that is being applied in order to prevent a U.S. recession. This does not mean the Fed can prevent recessions whenever it wants, nor does it mean they will try to prevent all future recessions, but it does mean they are trying to prevent this recession, which is an important departure from historical precedent.

We hope everyone enjoyed the fourth quarter of this year with family and friends, and we wish all of you a healthy and happy Winter. Please let us know if you have any questions. Thanks!

Best Regards, Erik

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