Stembrook Market Review — Fourth Quarter 2019

With global sentiment improving from signs of positive trade discussions between the U.S. and China and the dimming risk of a disorderly Brexit, equites continued to build on their gains for the year in the final quarter of 2019. Global equities were up 11.9% for the quarter and finished the year up 27.3%.[1] Global bonds also maintained their gains for the year and finished 2019 up 6.8%,[2] as over 80% of global central banks lowered policy rates.[3]

The strong performance in 2019 follows a decade of elevated returns from both equities and fixed income as highlighted in the center chart below. Some of the major themes that drove asset returns over the course of the decade were deeply discounted valuations following the financial crises of 2008, strong corporate earnings growth and very accommodative central bank policies, which kept interest rates low and in some cases, negative.

It is hard to determine what the next decade will deliver from a markets perspective, but from a macroeconomic perspective, conditions remain solid. As trade tensions have eased, sentiment has picked up. This is especially true in economies outside of the U.S. that are heavily dependent on manufacturing. Corporate earnings growth, which slowed in 2019, is expected to remain steady. We are also keenly aware of the many risks that can potentially disrupt the economy and markets. Elevated valuations in U.S. markets, tensions with Iran, the global trade environment and growing national debt in the U.S., to name just a few, are all risks that we are watching carefully.

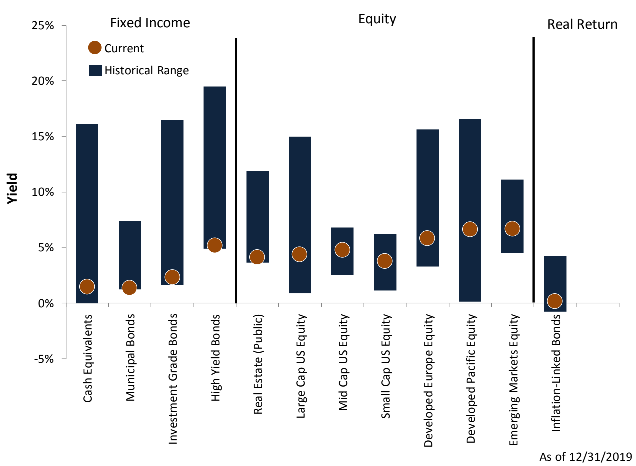
Our proprietary models forecast long-term, pre-tax returns ranging from 1% to 2% for fixed income-like asset classes and 4% to 11% for equity-like asset classes (see table to the right). Bonds have become less attractive as yields have fallen. We maintain target weight allocations for equities and fixed income, but are cautious as we move further into this bull market. Our more detailed observations and current portfolio positioning are outlined in the following comments.

Expected Market Returns and Risks
7-10 Year Horizon

		Pre-Tax Annualized Return	After-Tax Annualized Return	Volatility[1]
	Inflation	1.7%	1.7%	3.1%
Fixed Income	Cash Equivalents	0.7%	0.4%	3.5%
Fixed Income	Municipal Bonds	1.2%	1.2%	4.4%
Fixed Income	Inflation-Linked Bonds	1.8%	1.0%	5.6%
Fixed Income	Investment Grade Bonds	2.1%	1.1%	6.7%
Fixed Income	High Yield Bonds	2.0%	0.9%	13.2%
Equity	Real Estate (Public)	4.1%	2.2%	17.5%
Equity	Broad Market US Equity	8.8%	6.9%	16.9%
Equity	Developed Non-US Equity	8.8%	6.7%	21.4%
Equity	Emerging Markets Equity	10.5%	6.9%	29.6%

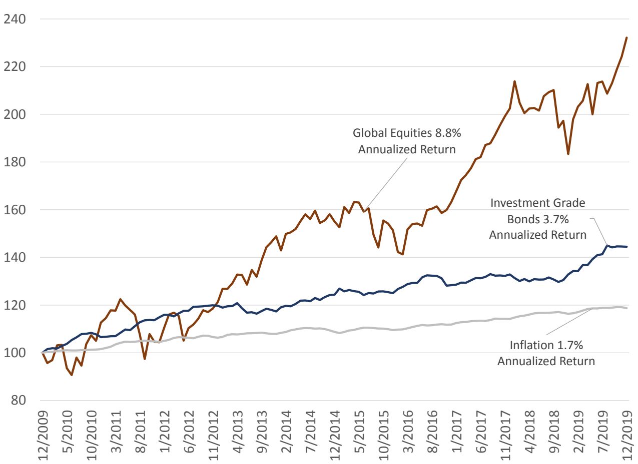
A sampling of return expectations produced by our models. Expected returns are projections and are not guaranteed.

Yields Across Asset Classes



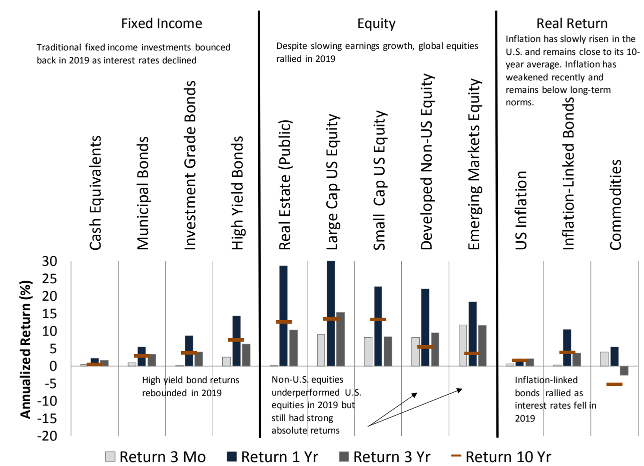
Yields are an indicator of future returns. Orange dots show current yields, blue bars show historical ranges. Yields are generally low versus their historical range.

Asset Returns in the 2010s



Equities and fixed income have both had strong returns over the decade, while inflation has remained low by historical standards.

Historical Market Returns



Historical market returns as of December 31st, 2019. Note that looking backwards at recent returns is not a reliable method for predicting future returns.

Global Asset Class Returns

Asset Class Name	Last 10 Years	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Small Cap US Equity	S&P 500 11.2%	Real Estate 28.6%	Infl-Indx Bnd 14.0%	EM Eq 18.2%	Small Cap 41.3%	Real Estate 31.8%	Real Estate 2.8%	Small Cap 26.5%	EM Eq 37.3%	CPI 2.0%	S&P 500 31.5%
Large Cap US Equity	Small Cap 11.0%	Small Cap 26.3%	Real Estate 9.2%	Real Estate 17.6%	S&P 500 32.4%	S&P 500 13.7%	S&P 500 1.4%	HY Bnd 17.5%	Intl Eq 25.0%	Inv Grd Bnd 0.0%	Real Estate 28.7%
Real Estate (Public)	Real Estate 10.5%	EM Eq 19.2%	Inv Grd Bnd 7.8%	Intl Eq 17.3%	Intl Eq 22.8%	Inv Grd Bnd 6.0%	CPI 0.8%	S&P 500 12.0%	S&P 500 21.8%	Infl-Indx Bnd -1.8%	Intl Eq 22.8%
High Yield Bonds	HY Bnd 6.2%	Commod 16.8%	HY Bnd 4.5%	Small Cap 16.3%	HY Bnd 7.4%	Small Cap 5.8%	Inv Grd Bnd 0.5%	Commod 11.4%	Small Cap 13.2%	HY Bnd -2.1%	Small Cap 22.7%
Emerging Markets Equity	Intl Eq 4.8%	HY Bnd 15.2%	CPI 3.0%	S&P 500 16.0%	Real Estate 1.9%	Infl-Indx Bnd 4.6%	Intl Eq -0.2%	EM Eq 11.3%	Real Estate 8.7%	Real Estate -4.0%	EM Eq 18.6%
Developed Non-US Equity	EM Eq 3.1%	S&P 500 15.1%	S&P 500 2.1%	HY Bnd 15.4%	CPI 1.5%	HY Bnd 2.5%	Infl-Indx Bnd -1.4%	Real Estate 8.6%	HY Bnd 7.5%	S&P 500 -4.4%	HY Bnd 14.3%
Investment Grade Bonds	Inv Grd Bnd 3.1%	Intl Eq 7.8%	Small Cap 1.0%	Infl-Indx Bnd 7.2%	Inv Grd Bnd -2.0%	CPI 1.3%	Small Cap -2.0%	Infl-Indx Bnd 3.6%	Inv Grd Bnd 3.5%	Small Cap -8.5%	Infl-Indx Bnd 10.6%
Inflation-Linked Bonds	Infl-Indx Bnd 2.9%	Infl-Indx Bnd 6.5%	Intl Eq -12.1%	Inv Grd Bnd 4.2%	EM Eq -2.6%	EM Eq -1.8%	HY Bnd -4.6%	Inv Grd Bnd 2.6%	Infl-Indx Bnd 3.0%	Commod -13.0%	Inv Grd Bnd 8.7%
Inflation	CPI 1.5%	Inv Grd Bnd 6.5%	Commod -13.3%	CPI 2.0%	Infl-Indx Bnd -9.4%	Intl Eq -4.5%	EM Eq -14.8%	CPI 1.8%	CPI 2.1%	Intl Eq -13.3%	Commod 5.4%
Commodities	Commod -4.4%	CPI 1.5%	EM Eq -18.4%	Commod -1.1%	Commod -9.5%	Commod -17.0%	Commod -24.7%	Intl Eq 1.6%	Commod 0.7%	EM Eq -14.5%	CPI 2.1%

Returns are arranged in columns, by year. Each color represents a different asset class. Each year, the leaders and laggards tend to shift. Diversification across a range of asset classes can smooth returns and enhance growth.

Economic Backdrop

- **The global economy continues to grow at a slow, albeit steady pace. Global weakness, which persisted over much of the year, began showing signs of improvement in the fourth quarter of 2019.**
- Global GDP growth for G-20 countries is expected to slip to 2% in the fourth quarter. [4] Inflation for the group increased at a 2.8% annualized rate.[5]
- There was notable economic weakness in Japan where the economy is expected to contract by nearly -3.7% in the fourth quarter. An increase to the consumption tax and softness in exports were primary factors. Trade tensions remained elevated through the majority of 2019.
- GDP growth in emerging markets economies remains unchanged from the third quarter at 4.1%.[4] Notable slowdowns in China and India, as well as economic contraction in Argentina, have contributed to slower growth in 2019.
- The record long, although not strongest, expansion in the U.S. continued in its 126th month. As we enter a new decade, the 2010s go on record as being the first decade to not witness a recession.[6]

Equities

- **As news of a potential Phase One trade deal with China reinvigorated investors' appetite for risk, equity markets rallied.**
- Large cap value stocks in the U.S. rallied in the fourth quarter, up 13.5%, outperforming growth stocks by nearly 2% for the period. Value stocks outperformed growth stocks by 0.8% for the year, up over 31.9%, after having trailed in 2017 and 2018. [7]
- Emerging market equities also had a very robust fourth quarter as trade tensions appeared to ease, for the time being, up 13.1% for the period.[8]
- Technology stocks continued their streak of stronger performance. The NASDAQ returned 16% for the quarter and was up 39.5% for the year. [9]
- One notable pocket of weakness in the fourth quarter was in REITs. After very strong performance, driven by falling interest rates, the asset class was only up 1.4% in the fourth quarter, but still finished the year up 28.7%. [10]

Fixed Income

- **Fixed income performance moderated in the fourth quarter after a very strong year, driven by falling interest rates.**
- High yield bonds were the beneficiary of a renewed appetite for risk in the fourth quarter, up 3.1% and 14.3% for the year.[11]
- Largely unchanged on the quarter, investment grade bonds in the U.S. were up 8.7% for the year.[12]

Current Positioning

- We maintain our **overweight to developed non-U.S. and emerging market equities**, where valuations and long-term return potential remain attractive.
- We also maintain our **underweight to large cap U.S. equities.** After years of outperforming, valuations have risen to less attractive levels.
- We favor **lower priced, value-oriented equities, both in the U.S. and abroad,** which tend to outperform the broad market over time, with less volatility.
- We remain **overweight municipal bonds** for taxable investors.
- Given our significant concerns regarding a longer-term, secular rise in interest rates and the resulting negative impact on bond prices, we continue to **hold shorter maturity bonds**, while steering away from **U.S. Treasuries.**

We continue to focus our efforts on helping you meet your financial objectives by following our disciplined investment approach. Our approach uses return and risk models, incorporating fundamental valuations and tax-efficient strategies. This investment discipline is tailored to your individual situation in our continuing effort to craft and implement your customized investment solution.

As we approach tax filing season, please reach out if you have any questions or need any assistance locating any specific tax forms. We are happy to work with you and your tax advisor to ensure that you have all the necessary documents and questions answered for your 2019 filing.

As always, we thank you for placing your trust in our investment management and advice and welcome your questions and comments at any time.

Peter D. D'Agati, CFA — Thomas Kosinski

Endnotes and Sources:

Text:

(1) Bloomberg: MSCI ACWI Total Return. 9/30/19-12/31/19, 12/31/18-12/31/19.
(2) Bloomberg: Bloomberg Barclays Global Aggregate Bond Index Total Return. 12/31/18-12/31/19.
(3) Goldman Sachs Investment Strategy Group 2020 Outlook.
(4) Bloomberg, Stembrook Research: GDP measures are based on the most recent annualized quarterly, seasonally-adjusted data. Statistics are stated in inflation-adjusted terms. Aggregate Statistics are weighted by each country's GDP translated into USD. Where available, official estimates are used. Where official estimates are not available, GDP data is based on Bloomberg Contributor Forecasted GDP. Emerging Markets measures are based solely on Bloomberg Contributor Forecasted GDP. As of 12/31/19.
(5) Bloomberg, Stembrook Research: Aggregate inflation statistics are weighted by each country's GDP translated in to USD. As of 12/31/19.
(6) National Bureau of Economic Research. As of 12/31/19.
(7) Bloomberg: S&P 500 Value, S&P 500 Growth. 9/30/19-12/31/19, 12/31/18-12/31/19.
(8) Bloomberg: MSCI Emerging Markets Total Return. 9/30/19-12/31/19.
(9) Bloomberg: NASDAQ 100 Total Return. 9/30/19-12/31/19, 12/31/18-12/31/19.
(10) Bloomberg: FTSE NAREIT All Equity REITS Total Return. 9/30/19-12/31/19, 12/31/18-12/31/19.
(11) Bloomberg: Bloomberg Barclays U.S. Corporate High Yield Index Total Return. 9/30/19-12/31/19, 12/31/18-12/31/19.
(12) Bloomberg: Bloomberg Barclays U.S. Aggregate Index Total Return. 12/31/18-12/31/19.

Charts:

Expected Market Returns and Risks, 7-10 Year Horizon: As of 12/31/19.
Source: Stembrook Research.
(1) Volatility is measured in terms of Standard Deviation. Standard deviation is the statistical measurement of dispersion about an average, which depicts how widely a stock or portfolio's returns varied over a certain period of time. Investors use the standard deviation of historical performance to try to predict the range of returns that is most likely for a given investment. When an investment has a high standard deviation, the predicted range of performance is wide, implying greater volatility. If an investment's returns follow a normal distribution, then approximately 68 percent of the time they will fall within one standard deviation of the mean return of the investment, and 95 percent of the time within two standard deviations. For example, for a portfolio with a mean annual return of 10 percent and a standard deviation of two percent, you would expect the return to be between 8 and 12 percent about 68 percent of the time, and between 6 and 14 percent about 95 percent of the time. Source: Morningstar.

Yields Across Asset Classes: As of 12/31/19.
Sources: *Cash Equivalents Yields* since March 1976. Ibbotson, Federal Reserve Bank, Thomson Reuters, *Municipal Bond Yields* since March 1988. Barclays Capital, Charles Schwab, BofA Merrill Lynch, Standard & Poor's/Investortools Municipal Bond Indices, *Investment Grade Bond Yields* since March 1976. Barclays Capital, *High Yield* since December 1984. BofA Merrill Lynch, Barclays Capital, *Real Estate (Public) Earnings Yield* since March 1976. NAREIT all Equity, *Large Cap U.S. Equity Earnings Yield* since March 1976. Standard & Poor's, BARRA, *Mid Cap U.S. Equity Earnings Yield* since June 1991. Standard & Poor's, BARRA, *Small Cap U.S. Equity Earnings Yield* since December 1993. Standard & Poor's, BARRA, *Developed Europe Equity Earnings Yield* since March 1976. MSCI Europe, Standard & Poor's Europe 350, *Developed Pacific Equity Earnings Yield* since March 1976. MSCI Pacific, S&P/Citi PMI Asia Pacific, S&P Asia 50, *Emerging Market Equity Earnings Yield* since December 1998, *Inflation-Linked Bond Real Yield to Maturity* since March 1997. Citi Yield Book, Federal Reserve Bank. Note: Yields are not perfect predictors of future returns and should not be used in isolation.

Asset Returns in the 2010s: 12/31/09—12/31/19.
Source: Bloomberg, Stembrook Research.
Indices: MSCI ACWI Total Return Index, Bloomberg Barclays Aggregate Bond Total Return Index, U.S. CPI Urban Consumers NSA (12/31/19 observation based on Bloomberg Consensus Median CPI Estimate).

Historical Market Returns: As 12/31/19.
Source: Bloomberg, Stembrook Research.
Indices: Bloomberg Barclays U.S Treasury Bills 1-3 Month Total Return, Bloomberg Barclays Municipal Bond 5 Year (4-6) Total Return, Bloomberg Barclays U.S. Aggregate Bond Total Return, Bloomberg Barclays U.S. Corporate High Yield Total Return, FTSE All Equity REIT Total Return, S&P 500 Composite Total Return, S&P SmallCap 600 Total Return, MSCI EAFE Total Return, MSCI EM (Emerging Markets) Total Return, Consumer Price Index – U.S., S&P 10 Year U.S. TIPS Total Return, Bloomberg Commodity (Total Return) Index.

Global Asset Class Returns: As of 12/31/19.
Source: Thomson Reuters, Bloomberg, Stembrook Research.
Indices: Consumer Price Index – US, U.S. 30-Day Treasury Bills, Bloomberg Barclays U.S. Treasury Bills: 1-3 Month Index, Citigroup Inflation-Linked Index, S&P 10 Year US TIPS Index, Bloomberg Barclays U.S. Aggregate Bond Index, BofA Merrill Lynch U.S. High Yield Cash Pay, Bloomberg Barclays U.S. Corporate High Yield Index, Dow Jones Wilshire REIT Index, FTSE All Equity REIT Index, S&P 500 Composite Total Return, S&P SmallCap 600 Total Return, MSCI EAFE Index, MSCI EM (Emerging Markets) Index, Dow Jones AIG Commodity (Totl Ret) Index, Bloomberg Commodity Index.

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Additional information is available upon request.