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FINANCIAL GROUP

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Portfolio Talk **Year End 2019**

"A cynic is a man who knows the price of everything and the value of nothing."

-Oscar Wilde

Cynics did not fare well in 2019. With the 4th Quarter decline in 2018 of close to 14% and approximately 7% for the year, being a cynic was the path of least resistance. However, bull markets climb the wall of worry! When bad news clouds the underlying fundamentals, less confident investors tend to sell when they should be doing the opposite. And what was the wall built with;

- China trade war
- Brexit
- Possible recession
- Russian/Trump investigation
- Slowing world economy
- Earning contracting
- Etc.…

Most economic indicators were showing signs of slowing and the underinvested equities market became further underinvested. We call this the coiled spring effect; push down on a coiled spring, release it and it will spring up. The more you push down the higher it will spring back. The markets reacted like the coiled spring, the selloff in the 4th Quarter of 2018 provided a healthy bounce back in 2019.

But why were equities up so dramatically in 2019, approximately 31%? Could it be a confidence factor? Confidence that:

- A Brexit Deal would pass and growth would resume in the Eurozone;
- Phase 1 of the USA/China tariff resolution would be accomplished fostering future growth;
- Recession is now a discussion pointing to 2021/2022;
- Political disruption with impeachment and possible removal of the President being resolved;
- Lower interest rates, Fed cutting 3 times.

Can the confidence factor continue, or will there be a point where business leadership and/or the consumer backs away? Maybe, but there's no sign of that happening at the present! Economic numbers continue to support the notion that the economy is stable. Take employment for example:

- Unemployment is at 3.5%, a 50-year low dating back to May 1969[1]
- Labor participation has grown to 63.5%[2], up from 62.4% in September 2015, the low point in this economic cycle. However, it is still below the record high set in January 2000 @ 67.3%.

While low unemployment is good for the economy, employment will probably be an issue for some time. The aging population and skill set gap will make finding qualified workers one of the greatest obstacles for employers. Logic would dictate that if 26.5% of the population is unemployed workers would be plentiful. Not so because the available workers vs. the skills needed do not match up, a problem we've written about before. Education and skills training are not helping the unemployed workers gain the skill set necessary to fill those job openings. This along with student debt may be causing the millennials to have a slower start in buying houses, starting families, etc. These are issues that may be preventing the economy from hitting full stride.

So, where to from here? Getting Phase 1 of the USA/China trade deal is a start. That along with a Brexit deal could add as much as ½% to GDP, according to Larry Kudlow, White House economic advisor. Growth should come mostly from the industrial and materials sectors. Heavy equipment manufacturers along with steel and aluminum companies could benefit most due to the reduction on tariffs making them more competitive. Secondly, sectors such as healthcare and financials could benefit due to corporations increasing capital expenditures, investing in their plant, equipment and employees.

The fear now is, have the markets advanced more than earnings warranted? Market returns tend to come from two parts:

- Price/Earnings (P/E) multiple expansion
- Corporate earning increasing

Last year's market increases came mostly from P/E expansion with earnings actually contracting by an estimated 1.1% from 2018 according to Data Trek Research. They further state that estimates for 2020 over 2019 have fallen from an increase of 12.9% in the second quarter of 2019, to 9.9% by year end. Goldman Sachs now expects estimates to come down even further to 6%! This means any multiple expansion would cause the value of the markets to become further extended making any disappointment, whether geopolitical or economic, to cause possible market disruption. This is why we believe in taking our equity exposure down to the lower range of our equity allocation and increasing cash. This is not a call that the markets are headed for a substantial decline but rather a rebalancing of the portfolios to reflect our clients risk tolerance. We still like growth companies, but value companies are attractive due to their lower P/E multiples and higher dividend yield. Staying invested for the long term is still one of the most important elements of success. That being said, we must stay in the allocation that best provides you, our clients, with the sleep factor needed!

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[1] Council of Economic Advisers: U.S. Unemployment Rate Falls to 50-Year Low, DTD October 4, 2019.
[2] U.S. Bureau of Labor Statistics.