QUARTERLY COMMENTARY

2020 HINDSIGHT

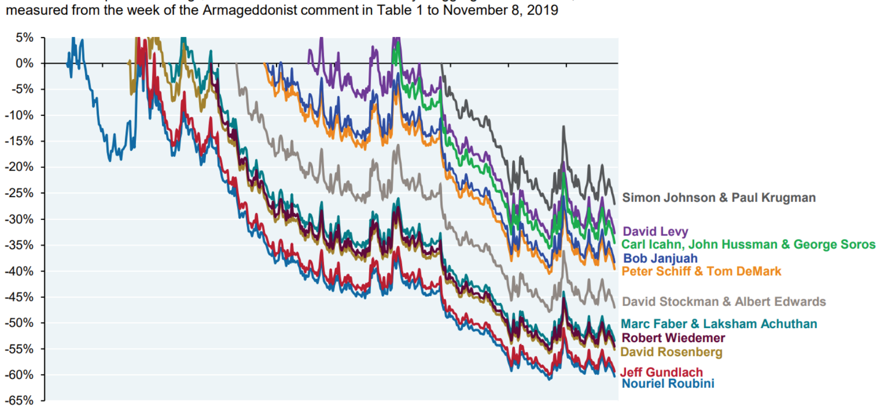
"Oh, it's so easy with hindsight, isn't it?"

Stocks broke out to all-time highs in the 4th quarter, after spending the prior three quarters struggling to meaningfully eclipse the previous highs set in October 2018. Even if we had been granted the magical opportunity to read last year's headlines in advance, our guess is that most of us would have vastly underestimated equity market returns in 2019. The S&P 500's gain of more than 31% last year represented its 11th-best calendar year return since the Great Depression, and soundly beat out almost all professional return forecasts. To say the least, last year's returns were a pleasant surprise to most investors, especially given slowing global economic growth, the vigorous (and seemingly never-ending) U.S.-China fight over trade and tariffs, the Trump impeachment saga, turmoil in the Middle East, and sluggish corporate earnings growth.

The impressive performance of equities in 2019, and the last decade in general, is a reminder that while markets can be volatile over various time frames, it pays to own a diversified portfolio of stocks over the long term. This fact never stops prognosticators from trying to call a "top" in the stock market. Throughout the last decade, a cottage industry of market pundits, PhD economists, and professional investors warned time and time again of a coming crash in the markets. These types of apocalyptic warnings tend to garner more than their fair share of attention in the financial media and among the broader investment community. This is not surprising to those of us who have followed the field of behavioral finance over the last couple of decades. The bulk of this academic research highlights a key idea: humans experience losses in a more emotionally intense way than equivalent wins. Because of this, we as humans are susceptible to a variety of biases that adversely affect our ability to make good investment decisions, especially during periods of market turmoil. Therefore, when a well-respected market sage warns us of looming danger to our portfolios, our fight-or-flight mechanism can be triggered.

Most of these market forecasters are intelligent, experienced, well-read, and forthright individuals. However, investors who chose to act on their recurring bearish pronouncements suffered real and potentially irreversible damage to their long-term returns. Michael Cembalest of J.P. Morgan Asset Management illustrated this point particularly well by showing the adverse impact on performance from shifting out of risk assets (i.e. the S&P 500) and into a defensive posture (i.e. the Bloomberg Barclays Aggregate Bond Index) following calls from several prominent investors.

The consequences of listening to the Armageddonists, 2010-2019
Performance impact of shifting $1 from the S&P 500 to the Barclay's Aggregate Bond Index, measured from the week of the Armageddonist comment in Table 1 to November 8, 2019



Source: JPMAM, Bloomberg. November 8, 2019. Using weekly S&P 500 and Barclay's Aggregate data.

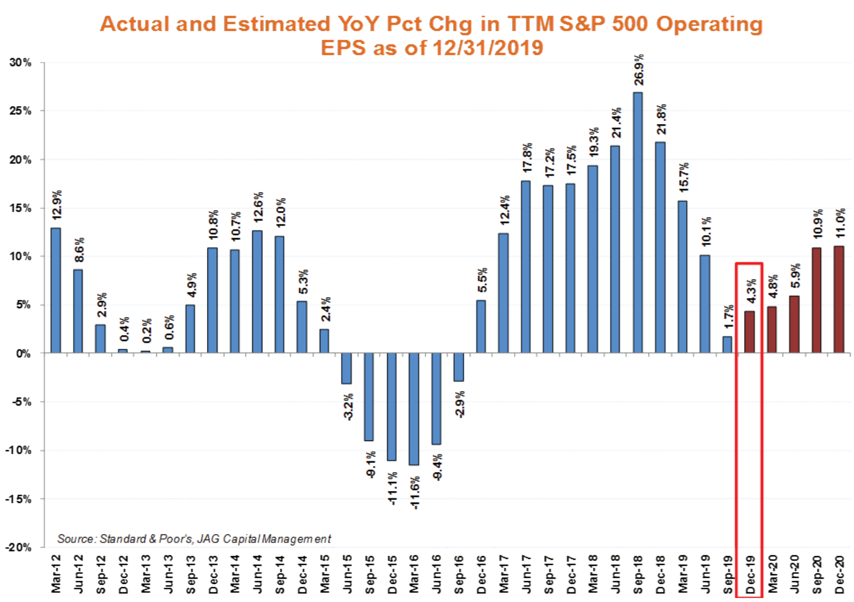
We do not highlight this data to diminish the importance of proper risk management, or to belittle any of the individuals who made these (dreadfully wrong, in hindsight) forecasts. Rather, we think this is a great reminder of the fact that brains and talent do not translate into market-timing skill. For all but a tiny percentage of individual and professional investors, trying to predict bear markets is literally a waste of both time and money. We are often reminded of famed investor Peter Lynch's adage: "Far more money has been lost by investors trying to anticipate corrections, than lost in the corrections themselves."

2020 OUTLOOK

We believe the market's strength last year was partially attributable to decent-but-not-spectacular earnings results and guidance, coupled with the Fed's accommodative stance on interest rates. Both conditions appear to remain in place as we kick off the New Year 2020. Although estimated S&P 500 operating earnings growth corporate earnings was a sluggish 4.3% in 2019, we note that current consensus S&P 500 earnings expectations imply solid year-over-year growth in 2020.

Assuming earnings come in line with consensus expectations over the next six quarters, full-year 2019 S&P 500 earnings will come in at approximately $158, and full-year 2020 earnings would clock in at over $175. This equates to year-over-year earnings growth of roughly 11% between 2019 and 2020. Our sense is that investors may not be ideally positioned to capitalize on the potential for double-digit earnings growth in the S&P 500 over the next year. Time will tell, but a potential gap between (low and declining) earnings expectations and (potentially stabilizing or strengthening) earnings fundamentals may be developing. If so, the closing of this gap could provide enough fuel for the stock market to continue its advance.

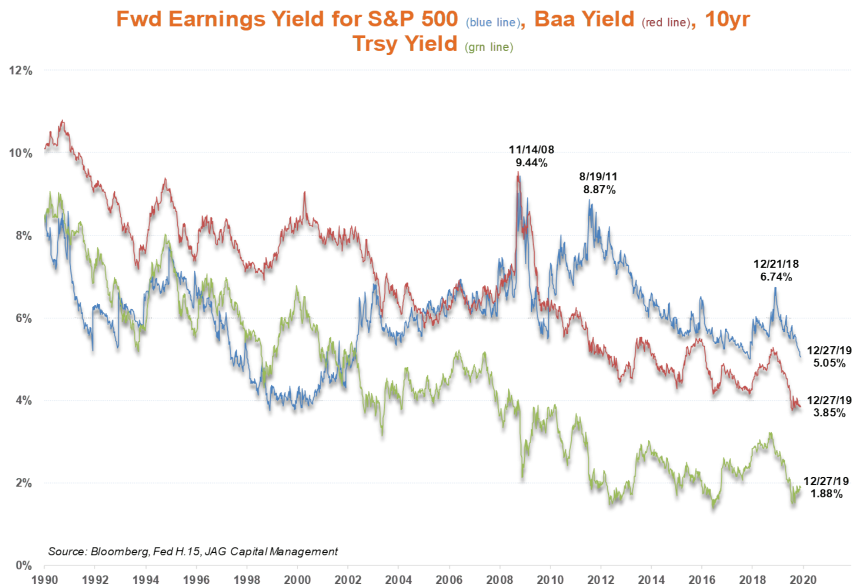
"Welcome to 'Should've, Would've, Could've', the investment hindsight show."

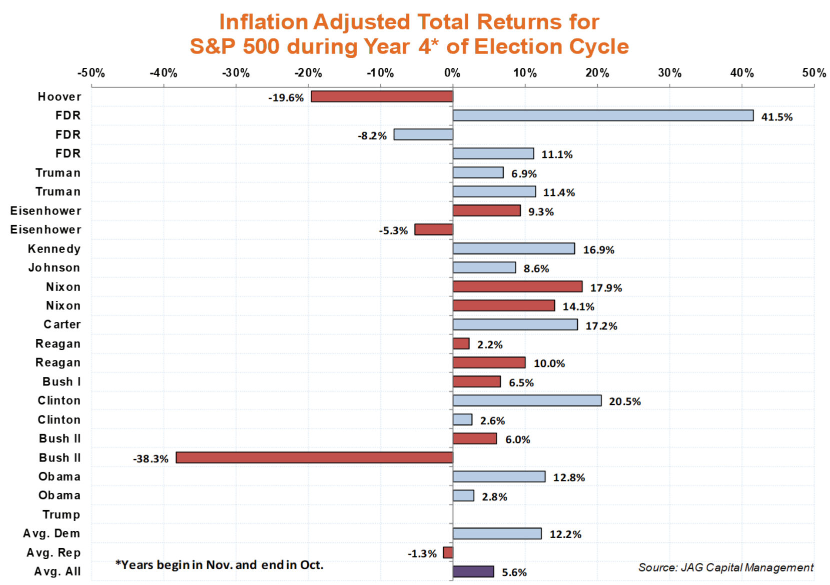


The interest rate backdrop also continues to favor equity investors, albeit at the expense of savers and bond investors. The Fed seems to have learned its lesson from late 2018, when they grew too hawkish on rates. Consensus expectations now call for the Fed to leave target rates unchanged for the next several months at least. Moreover, we believe the FOMC is growing increasingly comfortable with the notion of letting inflation run a bit hot into 2020. As Fed Chairman Jerome Powell said at a December 11 press conference, "…in order to move rates up, I would want to see inflation that's persistent and that's significant." If the Fed does indeed tilt rate policy in this direction, it could provide some cover for risk assets like stocks to work higher in the coming year.

Given sluggish earnings growth over the past year, almost all the market's gains came as a result of multiple expansion. While stocks are far from being classically "cheap" (as they were in 2011), we believe they are reasonable within the context of the current interest rate environment. As illustrated in the chart above, the current forward earnings yield for the S&P 500 (calculated as total S&P 500 earnings divided by the S&P 500 price level) has declined in recent months, as a direct result of expanding valuation multiples. However, the S&P 500's forward earnings yield remains at a premium to yields on lower-risk assets like BAA-rated bonds and 10-year Treasuries. As the chart shows, S&P 500 earnings yields routinely traded at a discount to bond yields throughout the 1990's, before the tech bubble popped and the economy slipped into recession in 2001-2002. Since 2010 however, equity earnings yields have exceeded BAA and 10-yr Treasury yields. To us, this implies that investors continue to distrust stocks, at least relative to bonds. More broadly, we think relatively attractive equity earnings yields have been an important contributor

"We must never take for granted the precious gift of hindsight."





As discussed earlier, there are several positive factors at play that make a contraction in domestic GDP anything but a forgone conclusion. We are cognizant of the fact that even the smartest and most diligent economists in the world struggle mightily – and often futilely - to predict the path of the global economy, interest rates, and inflation. For our part, we enter the New Year cautiously optimistic, but we expect more than a few twists and turns in the market's path as investors wrestle with the implications of the US election, the always-fascinating kaleidoscope of geopolitics, and the uncertain trajectory of the global economy.

All of us at JAG wish you and yours a healthy, happy, and prosperous 2020.

NORM CONLEY

CEO & CIO

to strong returns for stocks in the decade since the end of the 2008-2009 Great Financial Crisis.

A potential 2020 recession is a well-known and well-covered wildcard for investors. If the U.S. economy does enter a recession in the next year, then we can expect materially lower earnings for corporate America and most likely lower stock prices as well. We agree that the risk of a recession is a non-zero probability given ongoing trade tensions, slow global economic growth in the EU, and disappointing data from the ISM Manufacturing survey. But we would also point out a few positive developments as well: the Phase One trade agreement between the US and China appears solidified, the US housing market remains strong, US employment data continues to be quite robust, US consumer spending is firm, and global central bankers remain accommodative. Assuming the Phase One deal between the US and China gets signed, and the parties move forward with Phase Two of a broader agreement, the cooling of trade tensions could be an underappreciated catalyst for economic growth as corporations become more comfortable making capital allocation decisions.

The 2020 election news machine will spin up to a fever pitch as we progress through 2020, likely generating some volatility in equity markets. We've seen this movie before, and we note that returns for the S&P 500 in election years have historically tended to tilt positive, with the notable exception of year 4 of George W. Bush's term (2008).

DISCLOSURES

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