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ON OUR MINDS

2020 Foresight: Keeping the Faith

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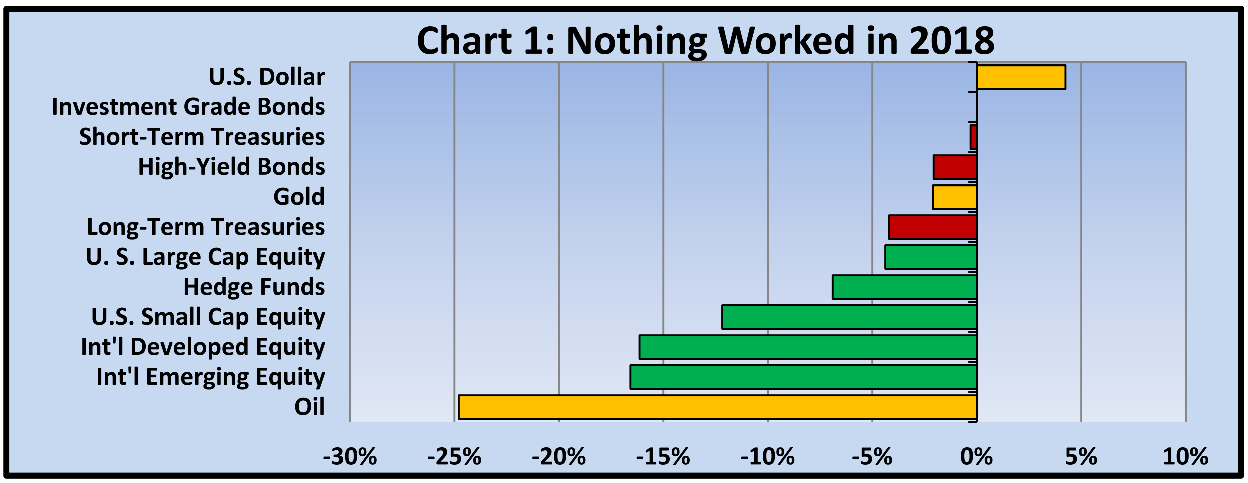
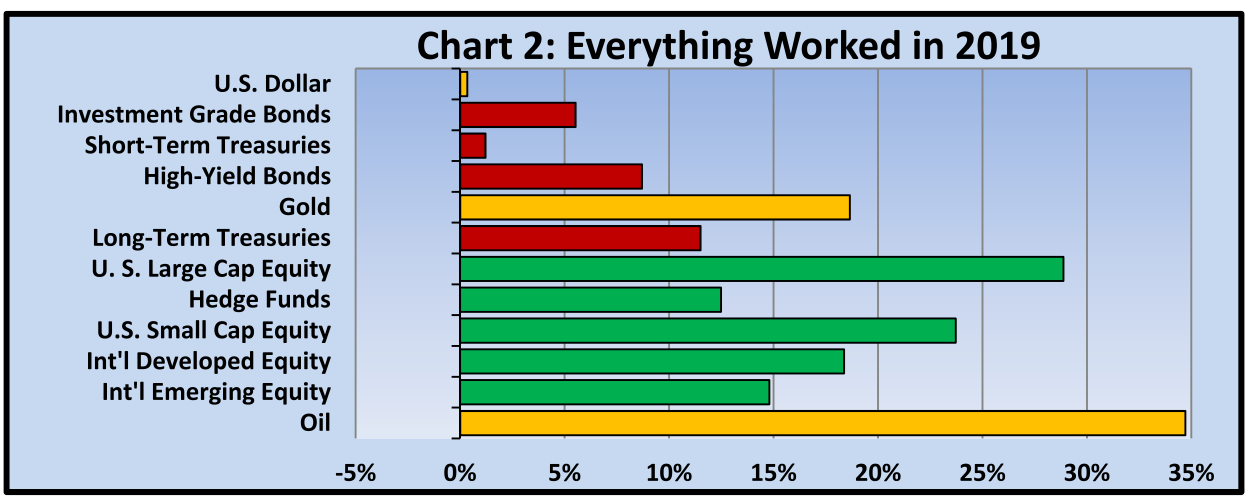
It was just a year ago that the storm front looked so ominous: Every major asset class had lost value in 2018; recession seemed just around the corner; fears of a trade war were rampant; and interest rates were two percentage points higher than they had been just two years earlier. Today, that fearful vantage point seems to have emanated from the longest time ago: contrary to most expectations, 2019 turned out instead to be an outstanding year across every major asset class. Charts 1 and 2 show the dramatic reversal from 2018 to 2019:





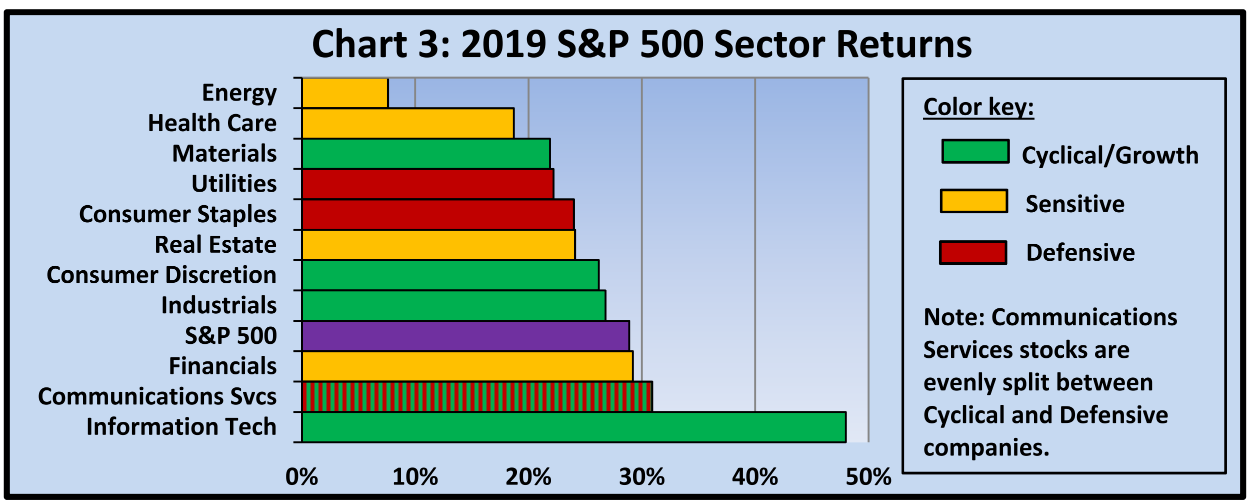
Source (Charts 1 and 2): FactSet

What does 2020 hold in store? Will stocks and bonds resume their traditional offsetting relationship, or continue to trade almost in lockstep? What is the outlook for corporate earnings and cash flows? Are valuations and fundamentals aligned or mismatched? Will exogenous factors affect markets? This is the time for our annual look forward, which we begin with a look back at the 2019 economy, markets, and investment performance; we then discuss our outlook and strategy for the coming year.

2019 Markets Review

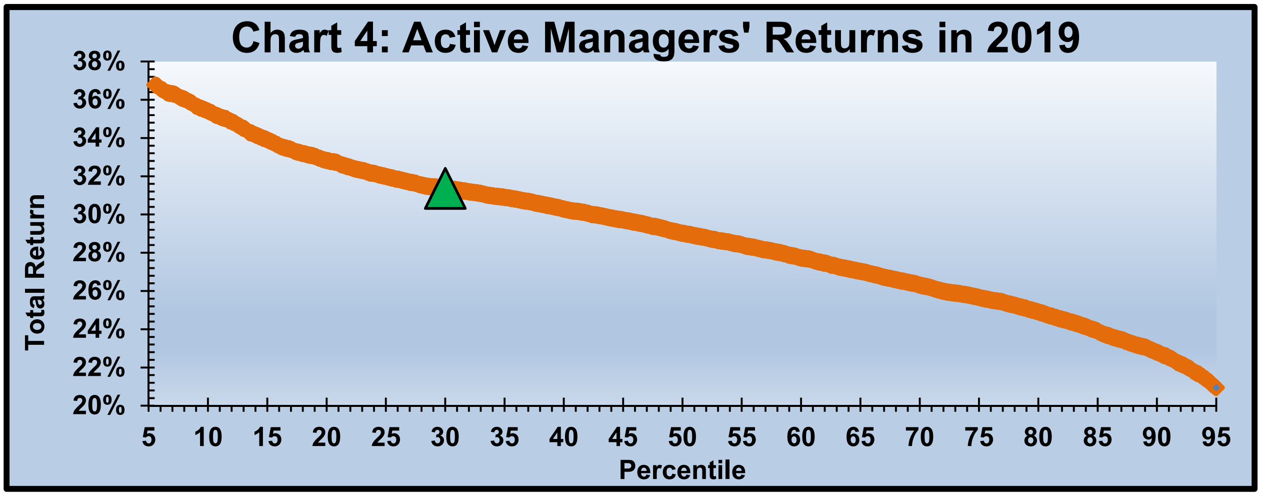
Domestic equities. From beginning to end, U.S. equities soared 31.5% last year, including dividends. While that was a great year on the face of it, investors painfully remember that it started at the bottom of the deepest correction of the past decade; stocks had lost 19.9% of their value by late 2018. Perhaps a better way to think about the U.S. stock market is that equities compounded by an average of 12.1% over the 2018-2019 period – still better than the long-term average of 9.5%, but not spectacular. Investors were wise to hang on through the deep 2018 correction, as well as through the two smaller downdrafts in June and August of last year.

Every sector of the U.S. economy contributed to the market's gains last year. Technology led the way, soaring 48%; the communications services sector (which includes Facebook and Google's parent Alphabet) rose 31%. By far the worst-performing sector, as shown in Chart 3, was energy – despite a 35% increase in the price of a barrel of oil. The stock market clearly distinguished between "risk-on" groups (noted in green in Chart 3) and "risk-off" (red) groups.



Source: FactSet

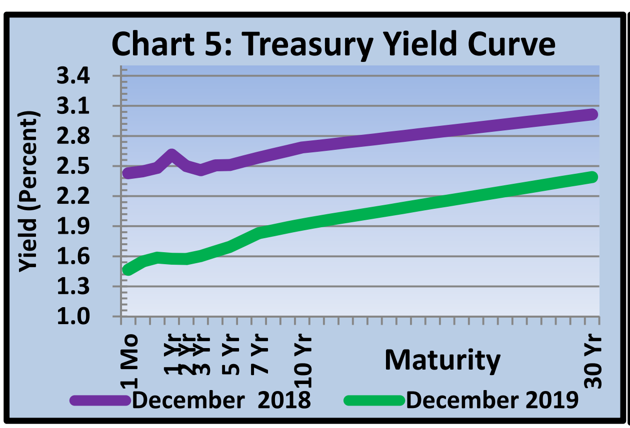
It was a year in which individual stock selection mattered greatly: The range of returns among active U.S. large-cap managers was substantial, as shown in Chart 4. In this chart, the orange line represents the individual returns of about 3,800 mutual fund managers surveyed by Morningstar, arrayed from best to worst. Managers in the tenth percentile saw a 35% return, while those in the 90th picked up only 23% last year. The S&P 500 return is highlighted with a green triangle; that the market finished in the 30th percentile indicates that active managers mostly missed out on a strong year. (The chart leaves off the top 5% and bottom 5% of managers to exclude outliers that could otherwise skew the data.)

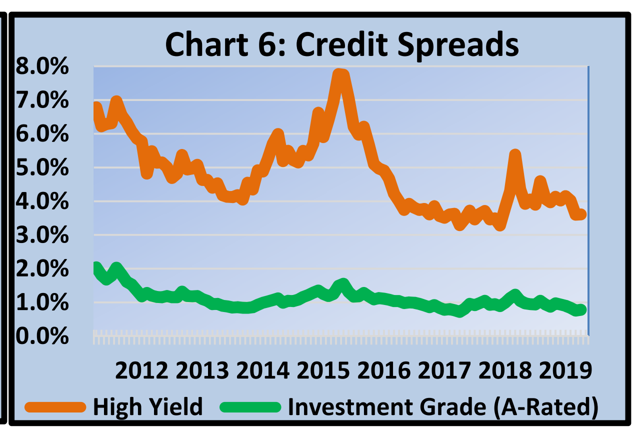


Source: Morningstar, Eastern Bank Wealth Management

Global equities. For the eighth time in the last nine years, international stocks badly lagged domestic equity markets last year, as foreign economies remained hamstrung by monetary policy missteps and political upheaval. That was especially true in Europe, which teetered on the verge of recession. With Germany demanding a weak euro and unwilling to provide fiscal stimulus while the rest of the Eurozone needed exactly the opposite, Europe was stuck in neutral all year. Across the globe, China's markets soared on optimism for an end to the trade war with the United States, even though the country's domestic economic growth was tepid and its financial sector sagged under the strain of excessive debt. The U.S. dollar neither helped nor hurt foreign markets, finishing the year almost exactly where it began.

Fixed income. The Federal Reserve cut its benchmark rate three times last year, and stopped the roll-off of its long-term balance sheet holdings. In doing so, Fed Chair Jay Powell essentially reversed everything that the Fed had done in 2018. A year ago, investors were concerned that an overly hawkish Fed would tip the U.S. economy into recession; through 2019, it became increasingly evident that Captain Jay would be more accommodating. Bond prices soared when interest rates across the maturity spectrum dropped by about 75 basis points (0.75%), as shown in Chart 5. Credit spreads, a measure of how much more yield investors require to own riskier assets as shown in Chart 6, collapsed as the risk of recession and default diminished.



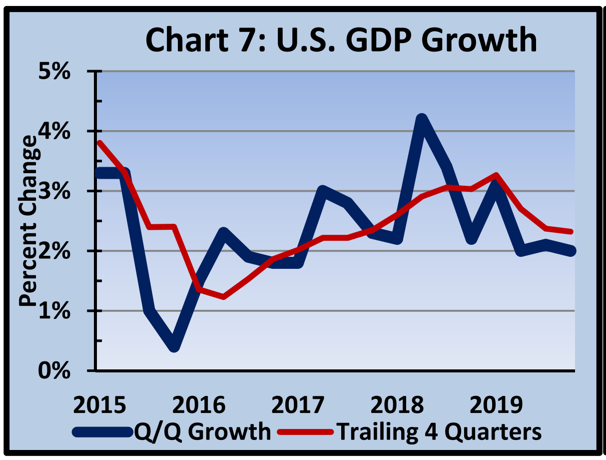


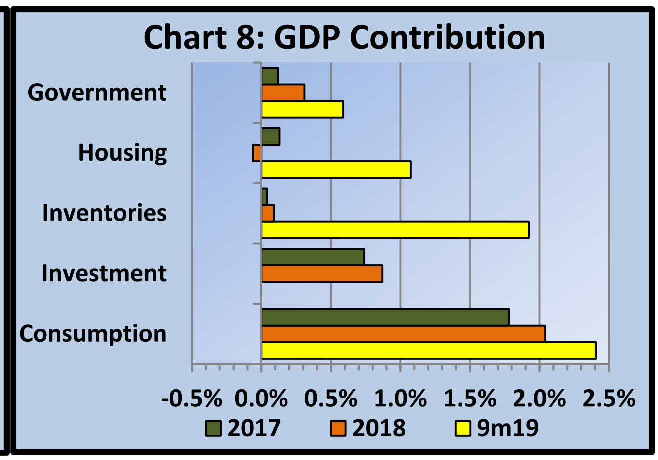
Source (Charts 5 and 6): FactSet

Domestic Economy

It's no wonder that markets were so happy last year. The U.S. economy grew about 2.2% after inflation last year, as shown in Chart 7; the fourth quarter was a bit softer. A year ago, many investors had feared that the economy would be in a deep recession by now, so a positive (if decelerating) growth rate was welcome news. Growth was driven by robust consumer demand, a stable and strong dollar, and a very healthy jobs market. The economy was neither too hot nor too cold; investors saw Goldilocks and said they love her just the way you are.

There were still plenty of reasons for concern, of course. Throughout the year, even a Phase One trade deal with China seemed almost out of reach; tensions in the Middle East threatened to turn into a hot war that would have dramatically altered the attitudes of consumers and investors alike; industrial spending on capital goods remained stubbornly weak; and the revenue shortfall from the Tax Cut and Jobs Act (TCJA) pushed the federal deficit to record levels.

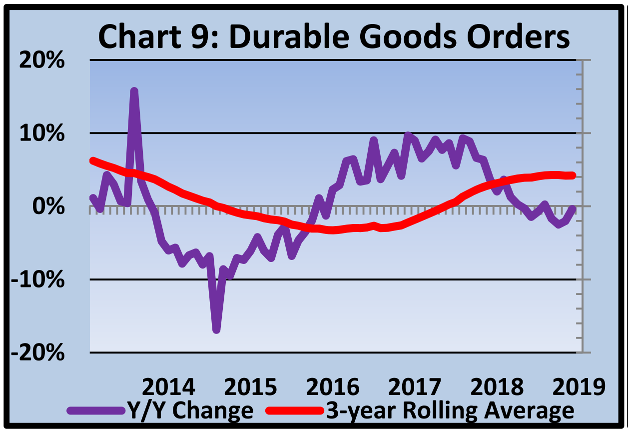




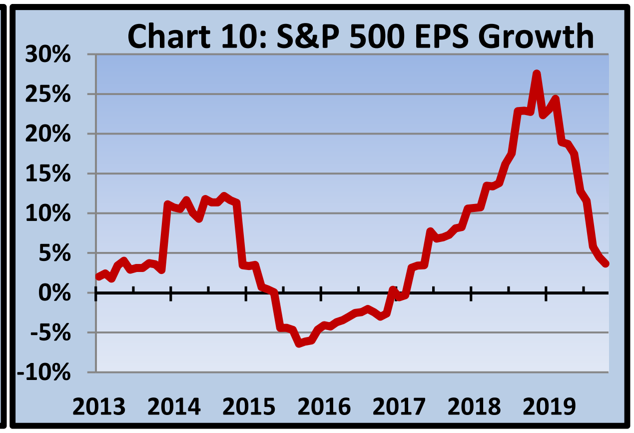
Source (Charts 7 and 8): FactSet

Inflation was subdued, not even once hitting the Fed's 2% target, as low import prices and disintermediation (the "Amazon effect") gave consumers more for their money. The strongest jobs market in the last half-century likewise helped consumer confidence, and retail sales were solid through the year. Chart 8 shows that consumption was the biggest contributor to GDP growth, as confident (and employed) individuals and families helped push overall consumption up nearly 3% last year.

The same confidence didn't apply in the corporate world, however. Perhaps it was a matter of trust, or lack thereof, as corporate CFOs didn't believe that a trade deal with China could be reached. That led many large corporations to reorganize their supply chains, moving out of China toward other emerging markets. Mexico was a substantial beneficiary, but even there President Trump's occasional threats to impose large tariffs scared corporate executives. The political theater led companies to build inventories as a hedge against a trade war, but also to put a damper on overall capital spending (Chart 9). Overall, corporate profits were weak throughout the year after a gangbusters 2018: Earnings per share growth for the S&P 500 companies slowed, in aggregate, from 23% in 2018 to only 3% last year (Chart 10); absent the benefits of share buybacks, earnings growth would have been negative.



Source: Census Bureau

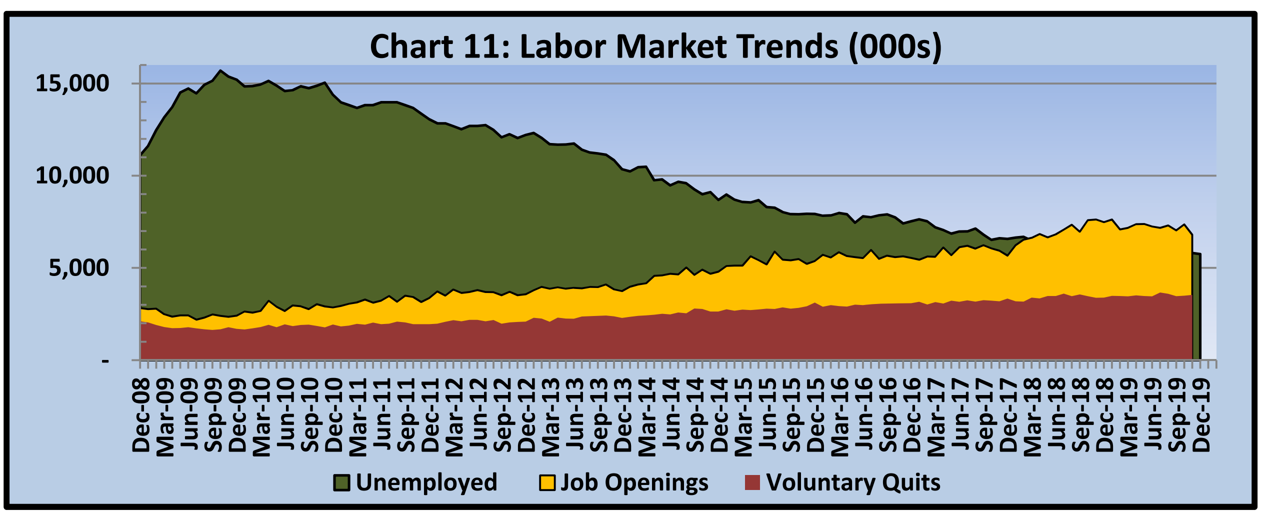


Source: FactSet

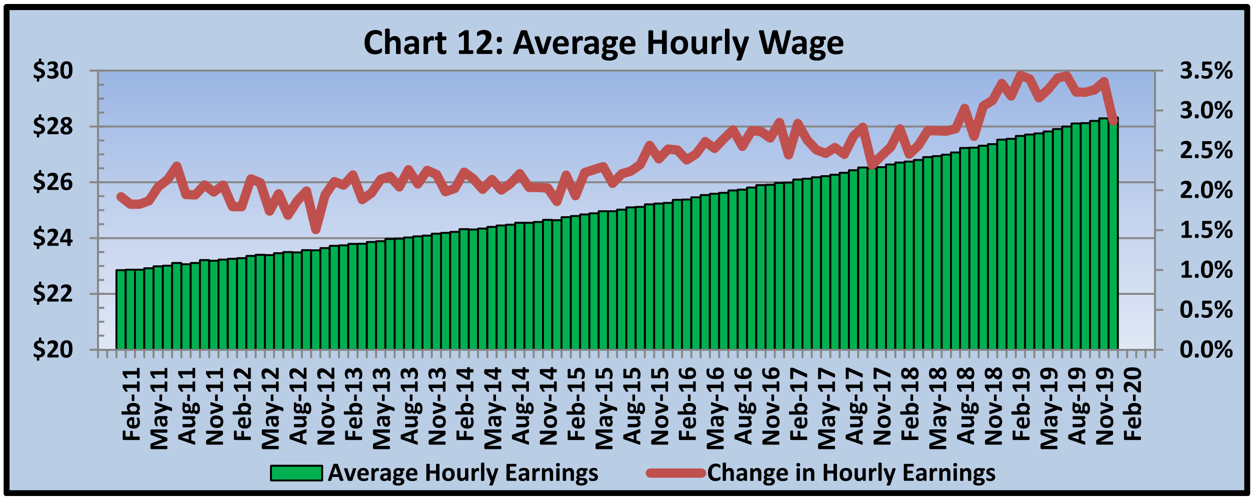
2020 Economic Outlook

U.S. GDP Growth. If the economy in 2018 was turbocharged by the Tax Cuts and Jobs Act and the deceleration in 2019 an almost inevitable consequence, where does that leave us in 2020? We anticipate GDP growth of about 2% this year, continuing the deceleration but still comfortably in positive territory. Key factors in our view are healthy consumer appetites; a rebound in the housing market driven by lower mortgage rates; steady employment gains; and perhaps a modest recovery in business investment now that the USMCA North American trade deal has been ratified and the first phase of a China trade deal has been signed.

Unemployment remains at fifty-year lows, and monthly job creation numbers have remained positive for a decade. Chart 11 shows that the U.S. currently has about a million more job openings than unemployed workers. This hasn't led to wage inflation (Chart 12), because more workers are coming back into the work force; labor force participation has crept upward in the past two years after a 20-year decline. Even so, substantial anecdotal evidence suggests that companies are having a hard time finding skilled workers (from truck drivers to tradesmen to white-collar professions), which is restraining overall economic growth.



Source: Bureau of Labor Statistics

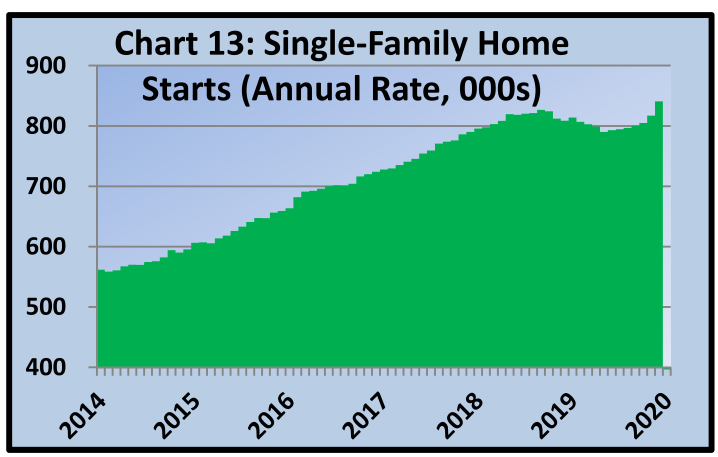


Source: Bureau of Labor Statistics

The three big uncertainties that clouded last year's forecasts seem to have cleared substantially in the intervening months. One is the ongoing trade negotiation with China: While the Phase One deal signed this month is a helpful step forward, it barely makes a dent in the full context of open issues between the two nations; even so, investors welcomed Phase One as a positive omen for the future of this process. If the U.S. and China can indeed agree on a package of intellectual property protections, market access rules, free flow of capital, and reduced tariffs, then the economies of both countries could accelerate due to an increase in trade. On the other hand, an impasse (or worse) could impede global trade and cut deeply into GDP growth.

The second important uncertainty last year was how the Federal Reserve would act. Here, too, the favorable developments in 2019 presage hope for a benign 2020. The Fed's most recent "dot plot" of expected fed funds rates, released last month, shows that the central bank now expects to hold short-term rates steady throughout the coming year. Investors agree: Treasury futures contracts imply that the probability of any rate change before next December is nearly zero. This convergence of Fed and market expectations is a good thing, but it also suggests that any surprise Fed actions could spook the markets.

Third, the housing market had come under significant pressure in 2018 as the twin hammers of tax reform and higher interest rates crushed demand. The TCJA greatly limited the tax deductibility of home mortgage interest and property taxes, which hurt the high end of the housing market but also filtered into more mid-range home prices. The Fed's four rate hikes in 2018 likewise caused mortgage rates to rise above 5%, which further scared off potential buyers.



Source: Census Bureau

By mid-2019, however, prices had adjusted to the TCJA and the combination of pent-up demand and lower mortgage rates pulled buyers back into the market. Home construction rebounded sharply in late 2019 after a very sluggish 2018, as shown in Chart 13. We think the improved picture will persist in the coming year; with a burst of new construction, home price increases will likely remain moderate.

Inflation. Ever since the current recovery and expansion began in 2009, inflation has been notably subdued, kept down by excess slack in the system – most notably initially in employment and more recently in production capacity. Both factors are tighter now than they were a year ago, but there is still no direct evidence that either one is close to the point of triggering higher inflation. While housing, energy, and health care costs continue to rise in excess of the overall rate of inflation, the prices of goods and other services have been more stable – held down, in part by disintermediation of retailers by Amazon and its online competitors. We think the spike in oil prices last year mainly offset the plunge in 2018; at about $60, we think oil prices will remain stable this year, as rising U.S. production and softer demand (due mainly to conservation and substitution by renewable sources of energy) will offset OPEC's production cuts. Overall, we see no reason to expect a meaningful change in inflation, which should remain in the 2% range through 2020.

Corporate Profits. While not the same as GDP, corporate profits do reflect economic growth and are a better measure of the stock market's earnings power. A year ago, we had forecast a sharp reduction in earnings growth from 23% to about 5%; we were still too high, as higher labor costs, supply chain challenges associated with the China trade war, and other factors took hold while the tailwinds of the TCJA tapered off. Heading into 2020, we think revenues are likely to surprise to the upside, as demand worldwide seems to be regaining some momentum. Companies still have the same challenges of rising labor costs, shortages of skilled staff, tariffs, and competitive pricing, but we expect revenue growth (and share buybacks) can still undergird about 5% to 8% EPS growth this year; we're a bit lower than the Wall Street consensus.

Interest Rates. We think that interest rates are likely to remain stable throughout 2020, after two years of sharp increases followed by equally quick decreases. The Fed overshot the mark in 2018, raising rates in anticipation of an inflation scare that never materialized; it cut rates in 2019 to fend off the risk that tariffs on Chinese imports would have stifled demand, but that outcome too never materialized. Today, the Fed is signaling that the economy is firmly in Goldilocks mode, and that rates will stay steady through the course of the year. There exists no inflationary pressure to support higher rates, and the economy's current strength doesn't require lower rates to help it stay healthy. After a brief inversion early last year, the yield curve (Chart 5) has a positive slope; we don't anticipate any meaningful change in the curve, though stronger economic data might steepen it somewhat.

International Economies. Most of the major world economies outside the U.S. are stumbling along without any sense of forward momentum. Resource-based economies like Canada and Australia are suffering from low commodity prices, while consumer-driven and manufacturing-based markets have banking or demand problems. Europe's economies, in particular, are caught in a maelstrom of negative interest rates, soft demand, a too-weak euro, Brexit, fallout from the China-U.S. spats, and political upheaval in some countries.

We think most developed nations will be lucky to achieve 1% GDP growth in 2020. It's possible that Germany will slip into recession because there is no political appetite for fiscal stimulus, and it's also possible that Brexit could still drive the United Kingdom into recession as well; of the two nations, we are more inclined to believe that Britain has the easier path toward resumed economic growth; its control of its currency and its willingness to provide both fiscal and monetary stimulus could shorten a Brexit-induced recession and accelerate recovery afterward.

Emerging markets are in better shape than the developed countries. China's Belt and Road free trade effort is supporting not only its own 6% GDP growth, but also the economies of many nearby emerging nations. These economies have historically been vulnerable to swings in the value of the U.S. dollar, as a strong dollar makes dollar-denominated sovereign debt very expensive to service; since we don't anticipate further strengthening in the dollar from already-high levels, we are not especially concerned about this issue.

2020 Tactical Asset Allocation

From late 2012 through year-end 2017, we had positioned client portfolios with a significant overweight toward equities. Three times since then (January 2018, January 2019, and May 2019), we pared back our exposure to offset what we judged to be too much exposure to a more expensive asset class. In retrospect, we were correct in 2018 but we should have let out more rope in 2019. As we enter 2020, we are once again trimming our equity allocation to a neutral position: Tactical equity weightings are now the even with long-term strategic weightings.

We reach this allocation by assessing the economic outlook and the probabilities of various scenarios. We think the most likely outcome is for more slow-and-steady growth, accompanied by stable interest rates and P/E ratios; in this scenario, we think both stocks and bonds will produce modest single-digit returns – perhaps 3%-4% for bonds, and 5%-7% for equities.

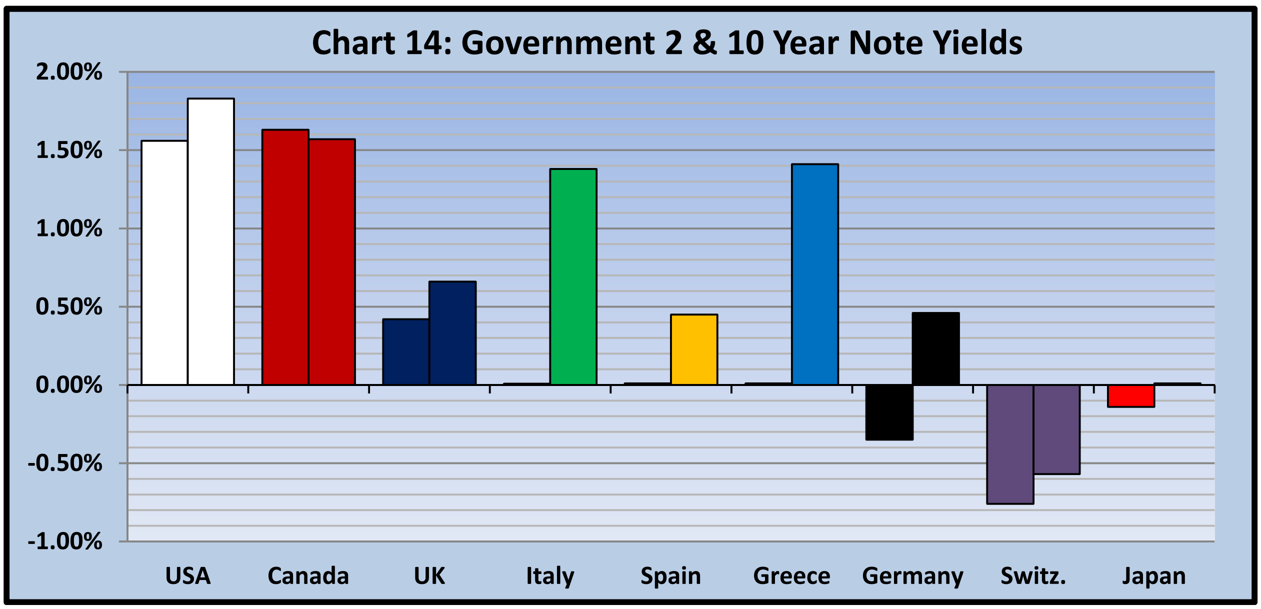
While we judge our base case scenario to have a high likelihood of occurring, we nonetheless recognize that a large number of factors could cause a significant downturn in the stock market. Among these low-probability events are a failed Phase Two trade deal with China, a sudden escalation of hostilities with Iran, domestic terrorism, a conviction in President Trump's impeachment trial, a no-deal Brexit, Fed policy missteps, and more.

Taking these varied outcomes and weighting them by our judgment of their probability of occurring, we see a high probability of small positive returns and a low probability of big negative returns; in our view, these outcomes offset each other and leave us favoring a neutral tactical allocation this year. In the following sections, we discuss our allocations within each asset class.

2020 Portfolio Construction

Bonds. American bonds are undoubtedly expensive to our eyes. The 10-year Treasury yield has historically approximated the sum of the inflation and GDP growth rates, which would suggest a current yield closer to 4% than the actual 1.8%. Yet there is nothing in our view that will cause the Treasury bond market suddenly to get cheaper (i.e., to push interest rates higher).

The U.S. Treasury bond market is often called the most liquid securities bourse in the world – so it might be surprising that we start our fixed income review in Europe, not New York. Chart 14 explains why we have to abandon the bond market's typical New York state of mind and instead look to the European Central Bank to key our fixed income strategy this year. The chart shows current 2-year and 10-year sovereign debt yields for several countries. Global investors have a stark choice: They can invest in a diversified economy with a strong government balance sheet but swallow negative yields (e.g. Germany or Switzerland), or they can get a decent yield with a decidedly inferior macroeconomic picture (e.g. Italy). By comparison, the U.S. bond market is heaven on earth: The strongest economy also has among the highest yields. Astonishing as it may seem, 10-year Treasury debt pays better than comparable Greek obligations.

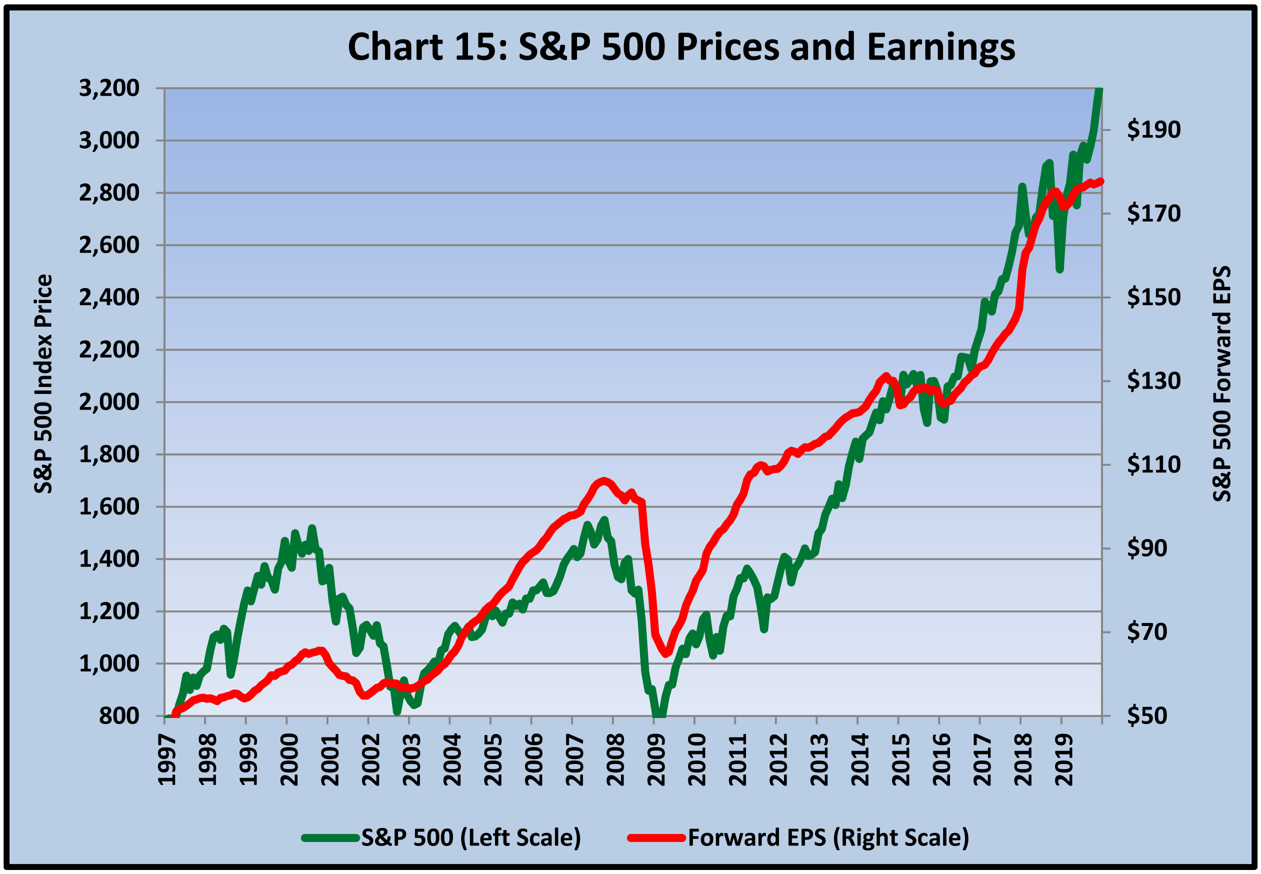


Source: FactSet

The reason behind this anomaly is the European Central Bank, which has engaged in a multi-year easy money campaign designed to spur borrowing and spending. The program has failed miserably because Europe's banks have too many bad loans tying up their capital and because fiscal policy has been too restrictive. New ECB President Christine Lagarde understands this; no one has to tell her about it. She wants to raise rates, but she is hamstrung out of fear that abandoning negative rates would push Europe into a recession. She's probably right.

For as long as the ECB maintains its current policies, U.S. debt will look comparatively cheap to foreign eyes, and that will keep a floor under U.S. Treasury prices. Money has been flooding into the Treasury market from overseas, with no sign of letup. American investors, desperate for yield, have taken on more credit risk, driving up prices of corporate debt as shown in Chart 6. With spreads so tight, we don't think investors are being paid to take credit risk today, so we have positioned our fixed income portfolios toward higher-quality Treasury and mortgage-backed securities. The difference in yield between AAA-rated mortgages and riskier corporate debt is the smallest it's been in a decade, suggesting that some value can be found in mortgages; in addition, repayment risk is low because many homeowners have already refinanced at very low rates, so there isn't much reason for them to do so again.

Equities. Chart 15 shows S&P 500 prices contrasted with year-ahead earnings. In the past twelve months, the S&P 500 index (in green) soared more than 30% while earnings per share (in red) barely budged; P/E ratios expanded more in 2019 than in any year in the past two decades. The stock market is now trading at close to 20 times year-ahead earnings, well above the historical average of 16x. (When the two lines in Chart 15 intersect, the market's P/E multiple is exactly 16; when the green price line is above the red earnings line, the P/E ratio is above 16 and stocks could be considered expensive.)



Source: FactSet

Investors today are paying rich prices for earnings growth that may not materialize; consensus estimates of 10% EPS growth this year seem a bit aggressive to us. The concept of paying a higher price for a riskier asset makes us nervous, so we have reduced our equity allocation to a neutral stance. Within U.S. equities, we have focused increasingly on quality, seeking blue-chip companies with attractive valuations and growing dividends; they are growing harder to find. We continue to invest across all economic sectors.

We maintain our participation in smaller companies through ETFs, in part because they trade at a discount to large-cap stocks, giving us an attractive valuation point. We have redirected some of our international equity participation, retaining our focus on emerging markets and reducing our holdings in Europe. We remain largely absent from Japan, where economic problems stem from its negative population growth rate.

To summarize, we are positioning our model portfolios and client accounts as shown in Chart 16:

Chart 16: Asset Allocation	**2020**	**2019**	**Change**
Tactical Equity Weighting	**0.0%**	**0.0%**	0.0%; neutral: no change
Equities:			
U.S. Large-Cap Stocks	77.0%	75.5%	+1.5%; tilt to quality growth
U.S. Mid/Small-Cap	4.0%	3.0%	+1.0%; cheaper valuation
SPDR S&P 500 Trust	5.0%	6.0%	-1.0%; taking profits
Biotech ETF	2.0%	2.0%	0.0%; no change
Total U.S.	**88.0%**	**86.5%**	+1.5%
Benchmark	**~82.0%**	**~82.0%**	
MSCI ACWI Ex-US ETF	6.0%	6.0%	0.0%; no change
Emerging Markets ETFs	6.0%	5.0%	0.0%; no change
Global Small-Cap ETF	0.0%	2.5%	-2.5%; lower visibility
Total International	**12.0%**	**13.5%**	-1.5%
Benchmark	**~18.0%**	**~18.0%**	
Fixed Income:			
U.S. Investment Grade	75.0%	75.0%	0.0%; nine-year ladder
Short-Term Corp. ETF	5.0%	3.0%	+2.0%; duration risk mgmt.
Intermed. Credit ETF	5.0%	14.0%	-8.8%; quality upgrade
Intermed. Gov't ETF	10.0%	8.0%	+2.4%; quality upgrade
Mortgage-Backed ETF	5.0%	0.0%	+5.1%; quality upgrade

Chart 16 shows targeted allocations for our Multi-Asset model using actively selected individual stocks and corporate bonds. We have developed comparable models for client portfolios that use mutual funds and ETFs instead of individual securities, and for variants of the Multi-Asset style including Core (which excludes international assets), ESG Sustainability, and Catholic styles. All of our model portfolios are derived from the same economic analysis and market interpretation, and therefore have analogous asset allocation targets. Individual client portfolios often differ from these models because of factors unique to each client, so these targeted allocations should be read as guidelines rather than as reflections of actual accounts.

2019 Report Card

Finally, we think it is appropriate to evaluate our investment decisions in the year just ended. People glass houses shouldn't throw the first stone, after all, so we think it's important to evaluate ourselves with honesty. This evaluation necessarily must cover only hypothetical guideline models: Since each client's portfolio is unique, it would be impossible to judge any individual client accounts here. Instead, we look back to our *On Our Minds* 2019 preview, "Take a Look Ahead," published January 17, 2019, to review our predictions and judge our work.

On the whole, we think the results were quite good:

- U.S. economy. We projected that the U.S. was on track for a slight deceleration to 2.3% growth, which turned out to be almost perfectly accurate. We got the details mostly right, too: Steady consumer demand, a tighter jobs market, and tame inflation. We incorrectly anticipated a rebound in business investment, but we correctly foresaw a dramatic slowdown in corporate earnings growth. We didn't expect the Fed to act so assertively to cut interest rates, but we did acknowledge that the trade negotiations with China would provide an ongoing source of uncertainty throughout the year.

- Asset allocation – by asset classes. Last January, we pared our equity positions from 4.5% overweight to neutral. In principle, this was a wise recognition of rising risk and elevated prices – but there's no escaping that equities had a banner year anyway, and we should have stayed overweight. Bonds did very well, but they couldn't catch the stock market. Within equities, our preference for large-cap U.S. over small stocks was vindicated as the large-cap S&P 500's 31.5% return far outstripped the 23.7% gain by the small-cap Russell 2000.

- Asset allocation – by geography. We had positioned our international equity allocations well below the benchmark's 18% weighting; this was a very smart decision. The U.S. outperformed just about all foreign markets yet again last year. Developed markets, as measured by MSCI's EAFE index, rose 18.3%, with most of continental Europe above 20% and the U.K. up only 12.8% due to Brexit uncertainty. Emerging markets gained 14.8%, on a size-weighted basis, but with wide variation; just about the only major international market to keep pace with the U.S. was China's domestic shares, which rode rising optimism over a trade deal to a 36% gain.

- Fixed income. In client fixed income portfolios, we aim to produce stable and predictable cash flows with limited reinvestment risk; most accounts use a multi-year individual bond ladder. This results in portfolios with shorter duration than most bond benchmarks.[1] Since our objective (cash flow and capital preservation) differs from that of the benchmark (total return), performance assessment is of only limited utility. We do use ETFs and some mutual funds to sculpt overall credit and duration risk. Through 2019, we kept our duration close to the market index, but shied away from credit risk due to tight spreads. The duration call was correct, but we were wrong to cling to quality when spreads got even tighter; high-yield had a superb year, which we missed.

- Equity stock selection – Core / Multi-Asset. Most of our client portfolios beat their benchmark indexes and were well ahead of our competitive peer group as well. Our Core equity portfolio models beat the S&P 500 for the third straight year, and were more than 250 basis points ahead of the median peer group return of 29.0%. Over the past one, three, and five years, our Core equity model was consistently ranked in the 28th to 31st percentile of our competitive peer group.

[1] We have begun shifting client accounts from a five-year ladder to a nine-year ladder, mainly to reduce the portfolios' natural drift to shorter durations.

- Equity stock selection – other models. Our ESG Sustainability portfolios outstripped their conventional counterparts, mainly because they mostly avoided the fossil fuel companies that were among the worst American stocks last year. On the other hand, our Dividend Plus models underperformed the Morningstar Dividend Composite Index because we haven't owned Apple in those portfolios; the stock's yield is below our minimum threshold, but Apple is still a large part of the index and the stock soared 86% last year. (Don't ask me why a stock with a paltry 1.0% dividend yield is included in the index; it seems to be one of the stranger[2] decisions Morningstar has made in its index construction.)

All in all, 2019 was an outstanding year for investors; everything worked. Our equity stock selection and our focus on cash flows in fixed income portfolios helped our clients enjoy returns that in most cases were ahead of other active managers and of the market indexes. We approach 2020 with hope for what can go right, but also keen awareness that prices are high, upside is limited, and much can go wrong. We begin anew each January at zero. We thank all of our clients for placing their trust in our stewardship of their financial assets, and we hope to see you all in the new year.

[2] If you think you've noticed several song titles from Long Island's most successful songwriter, you may be right; there are eighteen titles from the piano man embedded herein (allowing for "Captain Jay" rather than "Captain Jack"). Email me if you'd like the full list. With a nod to Bobbie Gentry, I almost succumbed to the temptation to title this article "Ode to Billy Joel."