ASSET STRATEGY CONSULTANTS

MARKET REVIEW

Fourth Quarter 2019

We are pleased to present *Market Review,* featuring a discussion of the Capital Markets during the Fourth Quarter 2019 and a summary of historical performance for the major asset style passive indices for the period ending December 31, 2019. We hope you find the information useful and helpful in your investment considerations.

We welcome your comments.

Andrew W. Conner, CFA
Principal and Chief Investment Officer
410-528-8282
www.assetstrategyconsultants.com

Asset Strategy Consultants

Founded in 1991, Asset Strategy Consultants provides investment consulting services to institutional clients representing $10.1 billion under advisement. Headquartered in Baltimore, Asset Strategy Consultants has offices throughout the East Coast.

THE MACROECONOMIC ENVIRONMENT

2019 – A Surprisingly Lofty End to the Decade

From our Year-end 2018 Commentary:

"As widely expected… the Federal Open Market Committee (FOMC) voted unanimously to increase its federal funds rate target by 25 bps, bringing it to 2.25%–2.50%…. the year-end read of fed funds futures prices indicated a nearly 90% probability of no Fed hikes in 2019… the FOMC also reduced its projections for 2019 rate hikes from three to two."

Those projections proved to be dramatically inaccurate. Indeed, the FOMC cut rates three times in 2019, bringing the target rate to 1.50%–1.75%. At year-end 2019, fed funds futures prices indicated a less than 50% probability of any Fed action in 2020, and the most recent "dot plot," which illustrates projections of FOMC members, implied no rate cuts in 2020 and only one in 2021.

Fed cuts fueled risk appetite and all major asset classes posted above-average returns—many of them in double-digit territory. While negative returns in 2018 are part of this picture, this degree of broad-based outperformance is unusual, if not unprecedented. The Fed's "pivot" was the most obvious contributor to stellar performance given that the economic picture was largely unchanged. Unemployment lingered at historically low levels, GDP growth hovered around 2%, consumers continued to spend, and inflation remained benign. The manufacturing sector continued to be a relatively lone point of weakness.

The U.S. economy closed the year with the unemployment rate at a 50-year low of 3.5%. The final reading for third quarter GDP showed a 2.1% gain, with personal consumption expenditures up 3.1%. November's headline CPI print was 2.1% (year-over-year) while the core measure was 2.3%. The Fed's preferred inflation gauge, the Core PCE Deflator, rose 1.7% over the trailing year. Manufacturing remained weak. The December Manufacturing ISM (released on Jan. 2) was 47.2, below 50 for the fifth consecutive month. Readings below 50 signal contraction.

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Equity markets were propelled to record highs and even fixed income investors were rewarded with nearly double-digit returns, an amazing feat given the sector's paltry yields. December capped a 129-month bull market for the S&P 500 Index, the longest ever and a cumulative return of nearly 500% since March 9, 2009.

Going into year-end, perceived progress in U.S./China trade negotiations, some degree of closure around Brexit, and expectations for the Fed to remain on hold for the foreseeable future overshadowed various areas of concern including unrest in Hong Kong, tensions in the Middle East and North Korea, the ongoing impeachment proceedings in the U.S., and ballooning federal debt. Further, Boeing's temporary cessation of 737 Max production is expected to trim 0.5% off first quarter GDP growth.

Outside of the U.S., rate cuts were prevalent across developed markets in 2019 but economic news was largely unchanged throughout the year. GDP growth across developed markets remained weak but largely positive. The most recent annual growth rate for the euro area was 1.2% and for Japan, 1.7%. As in the U.S., manufacturing continued to be a weak spot given a fall-off in global demand as well as the imposition of trade tariffs. The global manufacturing PMI was 50.3 in November, but that was due partly to modest expansions in emerging market countries Brazil, China, and India. Global inflation also remained benign at 2.0% in October, with the figure for developed markets being a more meager 1.5%, according to data from JP Morgan. ■

EQUITY MARKETS

The S&P 500 Index rose 9.1% in the fourth quarter, bringing its year-to-date result to a whopping 31.5%, the best calendar year return since 2013 and capping a decade of strong performance. Small cap stocks outperformed large caps in the fourth quarter, but trailed for the year (Russell 2000: +9.9%; +25.5% vs. Russell 1000: 9.0%; +31.4%). Growth stocks outperformed for both periods (Russell 1000 Growth: +10.6%; +36.3%; Russell 1000 Value: +7.4%; +26.5). From a sector perspective, Real Estate (-0.5%) was the only sector to post a negative return in the fourth quarter, though Utilities (+0.8%) was only modestly positive. Technology and Health Care (both +14.4%) were the twin "winners." For the year, all sectors posted double-digit returns—Energy (+11.8%) and Technology

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(+50.3%) were the bookends. The Tech sector is up a cumulative 840% since the market low in March 9, 2009. Notably, the stock market rally in 2019 was fueled largely by expansions in share price multiples in contrast to the rest of the decade, when returns were driven mostly by earnings growth. As a result, some term the market "overvalued" by a number of metrics relative to long-term averages.

Non-U.S. developed markets trailed the U.S. but were still up sharply in the fourth quarter and 2019 (MSCI ACWI ex-USA: +8.9%; +21.5%). Virtually all countries posted positive returns for both periods, though results were varied. Emerging markets outperformed developed markets in the fourth quarter but trailed for the full year (MSCI EM Index: +11.8% +18.4%). Chile (-8.8%; -16.9%) was the only country to deliver a negative return for both periods due to a sharp decline in the Chilean peso amid civil unrest. Russia (+16.8%; +50.9%) was the top performer for the year as its central bank aggressively cut rates. Returns for the BRIC countries were mixed. Brazil (+14.2%; + 26.3%) and China (+14.7%; +23.5%) also posted strong results while returns from India (+5.3%; +7.6%) were more modest. ■

FIXED INCOME

Fixed income markets posted strong returns in 2019 fueled both by falling interest rates and strong investor demand, especially for higher-yielding sectors. The 10-year U.S. Treasury closed the year at 1.92%, up from 1.68% at the end of the third quarter and down sharply from 2.69% at the close of 2018. The Bloomberg Barclays US Aggregate Bond Index rose 8.7%, the best calendar year return since 2002, with the lowest-quality tier of the Index up 16.4%. Fourth quarter gains were more muted at 0.2% as Treasury yields rose modestly. Corporate bonds were the best-performing sector in the fourth quarter and 2019 (Bloomberg Barclays Corporate Index: +1.2%; +14.5%) with long corporates gaining nearly 24% in 2019. High yield corporates also posted sharp gains; the Bloomberg Barclays Corporate High Yield Index rose 2.6% in the fourth quarter and 14.3% in 2019. Leveraged loans suffered outflows throughout the year, but still posted a solid return (CS Leveraged Loan: +1.7%; +9.0%). The Bloomberg Barclays US TIPS Index sharply outperformed the Treasury Index in the fourth quarter as inflation expectations rose, more than offsetting underperformance earlier in the year. The 10-year breakeven spread ended the year at 1.77%, up from 1.53% as of Sept. 30, 2019, and 1.71% as of Dec. 31, 2018. Worries over an inverted yield curve were a distant memory—the spread between the 2-year and 10-year Treasury was 34 bps at year-end. Municipal bonds (Bloomberg Barclays Municipal Bond: +0.7% and +7.5%) outperformed U.S. Treasuries in the fourth quarter and 2019 as the sector attracted record inflows.

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Overseas, rates followed a similar path with most higher in the fourth quarter but lower for the year. The amount of negatively yielding debt declined from a high of $17 trillion in August 2019 to less than $12 trillion as of year-end. The U.S. dollar gave up some gains in the fourth quarter, especially versus the euro (-3%), the Australian dollar (-4%), and the British pound (-8%). It posted a modest gain versus the Japanese yen (+0.6%). The Global Aggregate ex-US Index rose 0.7% in the fourth quarter on an unhedged basis but fell 1.1% on a hedged basis. For the full year, the hedged version outperformed unhedged (7.6% vs 5.1%). Emerging market debt benefited from both rate cuts and a risk-on environment. Local currency emerging market debt, as measured by the JPM GBI-EM Global Diversified Index, gained 5.2% in the fourth quarter and 13.5% for the year. Russia (+10.0%; +34.0%) was a top performer on the back of rate cuts and a stronger ruble. The U.S. dollar-denominated JPM EMBI Global Diversified Index was up 1.8% in the fourth quarter and 15.0% for the year with mixed results across its 60+ constituents. ■

REAL ASSETS

Real asset returns were mostly strong in the fourth quarter. The Bloomberg Commodity Index gained 4.4% and the S&P GSCI Commodity Index was up 8.3%; the deviation between the two indices was largely attributable to the price of oil (up 9% and a much larger allocation within the S&P GSCI Index). MLPs, however, declined (Alerian MLP Index: -4.1%). Spot gold prices were up 3.4%. The DJ-Brookfield Infrastructure Index rose 4.0%. REITs (FTSE Nareit Equity Index) posted a modest loss (-0.8%). TIPS also fared well as real rates fell; the Bloomberg Barclays TIPS Index rose 0.8%. For the full year, all returns were positive with Infrastructure (+28.7%) and REITs (+26.0%) leading the pack. MLPs (+6.6%) posted the lowest full-year return of the real asset category. ■

CLOSING THOUGHTS

While 2018 was an unusual year where virtually all asset classes posted negative returns, 2019 was equally rare with all major asset classes delivering above-average returns. As Callan's head of capital markets, Jay Kloepfer, fondly labels 2019 a "two standard deviation event" and certainly a year that few expected in spite of the disappointing results in 2018. The year serves as a good reminder of the importance of adhering to a disciplined process that includes a well-defined long-term asset allocation policy. ■

Source: Asset Strategy Consultants and Callan Associates

Important Disclosure Information

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PRELIMINARY RETURNS FOR VARIOUS PERIODS: 4Q19

		October	November	December	Last Quarter	Year to Date	Last Year	Last 3 Years	Last 5 Years	Last 10 Years	Last 15 Years
EQUITY	1 Russell:3000 Index	2.15	3.80	2.89	9.10	31.02	31.02	14.57	11.24	13.42	9.03
	2 Russell:1000 Index	2.12	3.78	2.89	9.04	31.43	31.43	15.05	11.48	13.54	9.12
	3 Russell:1000 Growth	2.82	4.44	3.02	10.62	36.39	36.39	20.49	14.63	15.22	10.50
	4 Russell:1000 Value	1.40	3.09	2.75	7.41	26.54	26.54	9.68	8.29	11.80	7.63
	5 Russell:Midcap Index	1.05	3.57	2.29	7.06	30.54	30.54	12.06	9.33	13.19	9.49
	6 Russell:Midcap Growth	1.85	4.98	1.17	8.17	35.47	35.47	17.36	11.60	14.24	10.15
	7 Russell:Midcap Value	0.54	2.67	3.04	6.36	27.06	27.06	8.10	7.62	12.41	8.82
	8 Russell:2500 Index	1.91	4.29	2.11	8.54	27.77	27.77	10.33	8.93	12.58	8.79
	9 Russell:2500 Growth	2.57	6.81	0.93	10.57	32.65	32.65	15.17	10.84	14.01	9.86
	10 Russell:2500 Value	1.44	2.45	3.02	7.07	23.56	23.56	6.12	7.18	11.25	7.67
	11 Russell:2000 Index	2.63	4.12	2.88	9.94	25.52	25.52	8.59	8.23	11.83	7.92
	12 Russell:2000 Growth	2.85	5.89	2.29	11.39	28.48	28.48	12.49	9.34	13.01	8.81
	13 Russell:2000 Value	2.42	2.34	3.50	8.49	22.39	22.39	4.77	6.99	10.56	6.92
	14 S&P:500	2.17	3.63	3.02	9.07	31.49	31.49	15.27	11.70	13.56	9.00
	15 S&P:400 Mid Cap	1.13	2.97	2.81	7.06	26.20	26.20	9.26	9.03	12.72	9.48
	16 S&P:600 Small Cap	1.95	3.06	2.99	8.21	22.78	22.78	8.36	9.56	13.35	9.20
	17 MSCI:ACWI ex US	3.49	0.88	4.33	8.92	21.51	21.51	9.87	5.51	4.97	5.25
	18 MSCI:EAFE	3.59	1.13	3.25	8.17	22.01	22.01	9.56	5.67	5.50	4.84
	19 MSCI:EM	4.22	(0.14)	7.46	11.84	18.44	18.44	11.58	5.61	3.68	7.48
	20 MSCI:ACWI	2.74	2.44	3.52	8.95	26.60	26.60	12.44	8.41	8.79	6.86
FIXED INCOME	21 Blmbg:Aggregate	0.30	(0.05)	(0.07)	0.18	8.72	8.72	4.03	3.05	3.75	4.15
	22 Blmbg:Gov/Credit	0.28	(0.09)	(0.20)	(0.01)	9.71	9.71	4.35	3.23	3.96	4.21
	23 Blmbg:Credit	0.57	0.19	0.29	1.05	13.80	13.80	5.75	4.39	5.32	5.10
	24 Blmbg:Corporate High Yld	0.28	0.33	2.00	2.61	14.32	14.32	6.37	6.13	7.57	7.20
	25 Blmbg:Municipal Bond	0.18	0.25	0.31	0.74	7.54	7.54	4.72	3.53	4.34	4.33
	26 Blmbg:US TIPS	0.26	0.15	0.38	0.79	8.43	8.43	3.32	2.62	3.36	3.78
	27 Blmbg:Glob Agg ex USD	0.96	(1.36)	1.09	0.67	5.09	5.09	4.36	1.62	1.50	2.41
	28 S&P:LSTA Levg Loan	(0.45)	0.59	1.60	1.73	8.64	8.64	4.35	4.45	5.00	4.74
	29 ML:US Treasuries 1-3 Yrs	0.33	(0.03)	0.21	0.51	3.55	3.55	1.84	1.39	1.22	2.15
	30 LIBOR - 3 Month	0.16	0.16	0.16	0.49	2.35	2.35	1.99	1.40	0.87	1.79
	31 3 Month T-Bill	0.19	0.12	0.14	0.46	2.28	2.28	1.67	1.07	0.58	1.39
REAL ASSETS	32 Blmbg:Commodity TR Idx	2.02	(2.56)	5.04	4.42	7.69	7.69	(0.94)	(3.92)	(4.73)	(2.55)
	33 GS Commodity Index	1.24	(0.01)	6.99	8.31	17.63	17.63	2.35	(4.32)	(5.44)	(4.63)
	34 MSCI:US REIT Index	1.42	(1.53)	(0.65)	(0.78)	25.84	25.84	8.06	7.03	11.93	7.88
	35 Alerian:MLP Index	(6.22)	(5.75)	8.53	(4.08)	6.56	6.56	(4.45)	(7.00)	4.19	6.40
	36 DJB:Glbl Infrastructure	0.24	(1.53)	5.33	3.97	28.69	28.69	11.15	5.75	10.22	9.66
	37 US DOL:CPI All Urban Cons	0.23	(0.05)	--	--	--	--	--	--	--	--