

**Year-in-review** – What a difference a year makes. This time last year the markets were coming off a painful fourth quarter that saw the S&P 500 fall -13.6% and small-caps hit bear market territory with a loss of -20.3%. Fear was palpable and all anyone wanted to talk about was the risk of global recession. Fast forward 12 months and the conversation has changed entirely. The equity markets closed 2019 on a strong note with gains of between +9.0% and +11.3% in the final quarter. This brought the YTD returns to +31.3% for the S&P 500 and +26.8% for global equities. For most equity asset classes this was the best year since 2013. While it is tough to say that economic optimism drove returns, certainly accommodative central banks and a modest lessening of political risks played starring roles. About the only pocket of weakness was in the energy space. Large-cap oil stocks were up just +8.5% in 2019 while oil service stocks were hit with a -3.6% loss. This was despite the +33.4% increase in crude oil prices.

In the world of fixed income it was a similar story. Bond investors were generally rewarded as interest rates fell globally and credit spreads tightened. The benchmark yield on the 10-year Treasury fell from 2.69% at the end of 2018 to 1.92%. Intermediate-term Treasury bonds gained +8.0% for the full year while long-term bonds were up over +14%. Short-term government bonds were up a less impressive +3.4%.

**Portfolio Update** – It was a strong year for all allocations with most portfolios in-line with their benchmarks. Surprisingly, for the first year in our history both the active and exchanged-traded fund (ETF) all-equity allocations had exactly the same return!! Some of our active funds performed admirably in 2019. For example, Goldman Sachs Small/Mid gained +37.7% versus +26.1% for the mid-cap index and Harbor Capital Appreciation was up +32.8% versus +30.8% for the growth index. It was also good to see large-cap value beat large-cap growth for the first time in a long time. Once again, our socially conscious portfolios edged out the other allocations by a small amount in 2019 due to solid manager performance and an underweight in the energy sector. For example, the Pax

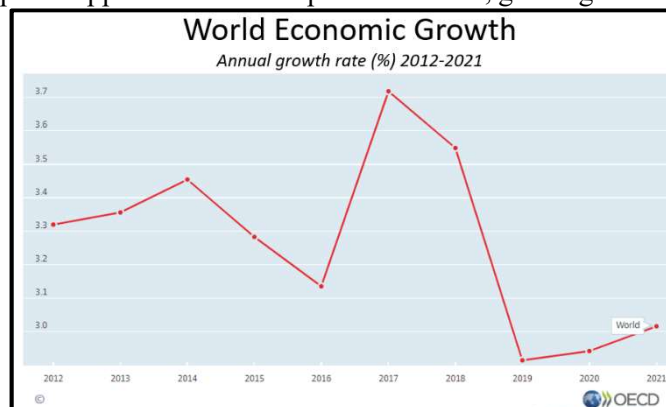
Market Benchmarks			
Market Indices	4th Qtr	YTD	3-Yr An
S&P 500 Index	+9.0%	+31.3%	+15.1%
Russell 2000	+9.9%	+25.4%	+8.5%
Global Equities	+9.1%	+26.8%	+12.5%
Int'l Index (EAFE)	+7.7%	+22.0%	+9.6%
Emerging Mkts	+11.3%	+20.1%	+10.3%
Other Indicators			
	12/31/19	9/30/19	12/31/18
Fed Funds Rate	1.5%-1.75%	1.75%-2%	2.25%-2.5%
2-Year Treasury	1.57%	1.62%	2.49%
10-Year Treasury	1.92%	1.68%	2.69%
S&P 500 P/E Ratio*	18.2	16.8	14.4
Crude Oil	\$61.16	\$54.07	\$45.84
Core Inflation	1.6%	1.8%	1.9%

\*Forward 12-month operating earnings per S&P

World Global Environmental fund was up +27.8% in 2019 versus +22.0% for the international index while the DFA US Sustainable fund was up +32.5%, +1.2% better than the S&P 500.

We only made one change to the active allocations in the fourth quarter. We cut our position in Oakmark Select by half in most risk zones and moved the proceeds to the Schwab 1000 fund. We have been wrestling with what to do with Oakmark for some time as his concentrated approach to investing leads to some large swings in relative performance. We used the pop in performance in the fourth quarter (he beat his index by +1.7% during the quarter) to trim the position. We still have confidence in manager Bill Nygren's approach, we just feel it should be a smaller part of the allocations going forward.

**From Growth Slowdown to?** – If you zoom out and look at the global economy as a whole, the big story of the last couple years has been one of slowing growth. As you can see below, global growth has slowed from +3.7% at the end



of 2017 to +2.9% currently. No country has been immune, and Germany and Japan in particular have been flirting with recession. There are a number of well known reasons for this. The drag from the trade war has certainly played a role. Just as important is the fact that corporate investment has dried up due to the uncertainty. Tighter monetary

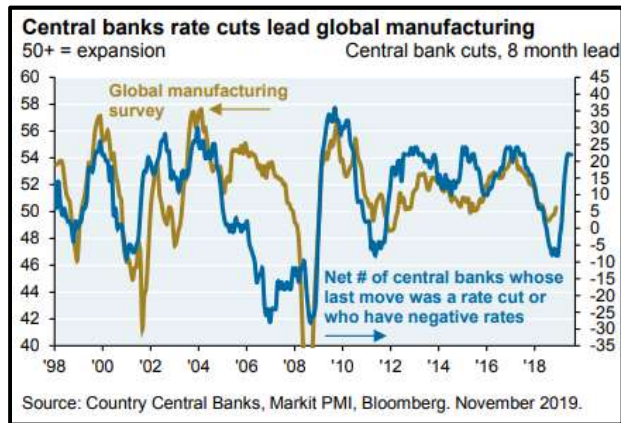
policy is also a factor as the Fed tightening in 2017 and 2018 served as a drag.

The market in 2019 was strange in the sense that the equity market rallied but growth continued to slow around the world. The yield curve inverted at one point in the U.S. (normally a sign of a pending recession) and the amount of bonds with negative yields hit new highs around mid-year. However, supportive central banks were investor's best friend! The vast majority of global central banks ended up cutting rates last year, and this proved pivotal. Going forward the key question will be whether central bank actions in 2019 will translate into a better economy in 2020? If global growth continues to deteriorate, overextended markets will be at risk. However, if growth stabilizes and starts to improve, we could see another decent year. We are in the latter camp barring an unforeseen shock.

**The Case For a Rebound** – Looking back at the chart on page one you can see that the OECD expects growth to pick up in 2020 and 2021. Why? A key catalyst for a better growth environment is simply the fact that interest rate cuts stimulate the economy. The chart above shows global manufacturing versus the number of central banks cutting rates. The point of this chart is that monetary policy ultimately works, albeit with a lag. Furthermore, if the trade truce lasts, we could see corporate investment pick up in 2020 from very low levels.

Another key factor that's worth reiterating is just how robust the U.S. consumer's position is at the moment. The unemployment rate is at a 50-year low and consumers are well positioned to continue spending. Encouragingly, the best wage growth is taking place at the lowest income levels, a sign that labor markets are tight (chart below). To get a recession in the U.S. we would need to see the consumer buckle for some reason. This is unlikely to happen in 2020, and if anything, spending could accelerate. Most consumers

should also see their largest asset (their home) appreciate. While we don't foresee large gains in home prices, the national inventory of new and existing homes is at its lowest level since 1985, as is the vacancy rate. Furthermore, mortgage rates are low and income growth is picking up, all ingredients for a decent housing market. Now don't get us wrong, there are



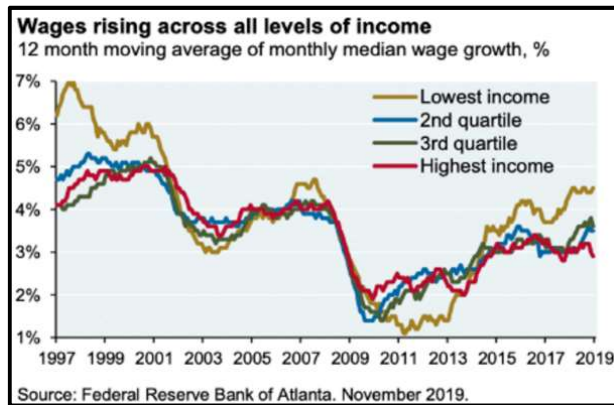
has cut taxes for households and ramped up infrastructure spending over the last few months, and this should translate into modestly better growth. We are already seeing manufacturing activity pick up, and if the trade truce lasts, this should persist.

**The Fed's U-Turn** – It is hard to stress enough how important the change in Fed policy was in 2019. If Chairman Powell had kept on with his tightening policy it is quite possible we would have seen a recession. As it was, he quickly backtracked in January. If you remember, we likened the bear market in the 4<sup>th</sup> quarter of 2018 to a similar decline in 1998 (we termed it an 'event driven bear market'). In both cases the central bank responded aggressively enough to prevent recession.

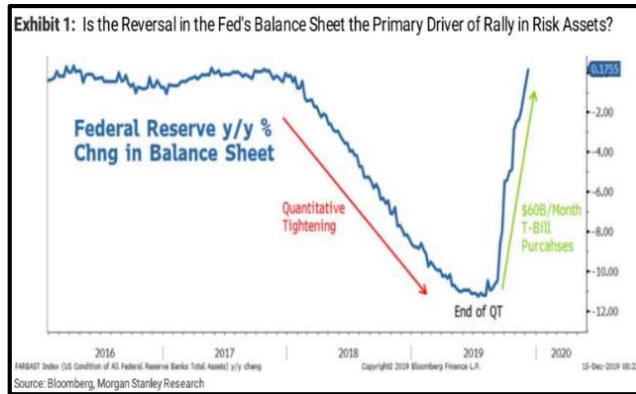
How will policy change in 2020? When it comes to rate adjustments, we think we see very little movement. The Fed has communicated that the bar to move either way is pretty high. Interestingly, Chairman Powell has stressed that the bar for **rate increases** is much higher than originally thought and that it would take a 'significant' increase in inflation to trigger a rate hike. How big of an increase? They haven't been explicit yet, but the Fed appears to be moving towards something called 'average inflation targeting.' What this means is if the target inflation rate is 2% and actual inflation has been running at 1% for a number of years, policy makers will accept inflation above 2% for a period of time so the average equals 2%. This is important because it means the Fed won't proactively short circuit a growth cycle by raising rates too soon. In retrospect this is what happened in 2018.

The Fed raised rates too far too fast.

The other question concerns the Fed's balance sheet. In 2018 the Fed started to unwind their quantitative easing programs of 2008-2014. This entailed draining excess reserves from the banking system, and as you can see from the chart at the top of the next page, the balance sheet contracted



throughout much of 2018 and 2019. However, this program was sharply reversed on October 11<sup>th</sup> when short-term ‘repo’ rates soared and the Fed stepped in to provide liquidity. They have committed to buy \$60bn/month of T-Bills through June. This move certainly supercharged the risk asset rally in the 4<sup>th</sup> quarter of 2019. How this policy evolves this year will be something to watch closely. Will the Fed continue to grow their balance sheet beyond the middle of the year, something that should support risk assets? Or will they once again try to shrink it?



will this be? If we thought bond yields were going to soar this year then we would have a problem. But we don't (see the next section). Equity returns in 2019 were driven almost entirely by multiple expansion. We think returns in 2020 will be driven by earnings. On this score the more conservative analysts see growth of roughly +6% this year versus basically

flat performance in 2019.

**Political Risks Become a Touch Clearer** – Last year we started to see some of the political risks that were hanging over the market's head become a little less worrisome. Take trade to begin with. We won't recap all the steps (and missteps) in the trade battle with China, but the recent developments have been incrementally positive. After new tariffs were levied on September 1<sup>st</sup>, the U.S. and China agreed to hold talks that same month. The outcome of this was the so called 'Phase One' deal in October and a delay in further tariff increases. This deal was finalized on December 15<sup>th</sup>, and while the details are still somewhat sketchy, the U.S. agreed to a limited tariff rollback and China agreed to increase purchases of agricultural products by \$32bn over two years. China will also implement greater intellectual property protections and end the practice of forced technology transfer. This issue is far from solved, and we are probably just a tweet away from another round of angst around the issue. But the nearer we get to the election the less likely President Trump is to blow up the global trading system.

It is worth pointing out that investor behavior doesn't show the typical signs of exuberance you'd expect at a market top. Usually investors' dollars chase returns, but as you can see from the chart at the top of the next page, we saw the exact opposite in 2019. Investors pulled over \$160bn from equity mutual funds and ETFs last year, the largest amount on record. Analysts are scratching their heads over this. Will this turn around in 2020 and prices get bid higher? Or has something fundamental changed? Are baby boomers on the cusp of retirement going to always seek safety in cash and fixed income given two big bear markets in twenty years? Only time will tell.

The other major political event that went from headwind to something less ominous concerns Brexit. Boris Johnson won a surprisingly large margin in the most recent election, and this all but guarantees that Brexit will happen in 2020. However, from a market perspective, the good news is that a 'hard Brexit' where the U.K. breaks away without a deal is very unlikely. Obviously, coming up with deal in 2020 will be a challenge, but the worst-case scenario of no deal is off the table for now.

**Fixed Income Outlook** – We will be the first to admit that we didn't expect bond yields to fall as much as they did in 2019. The yield on the 10-year Treasury got as low as 1.43% in early September last year. This is lower than the level seen during the financial crisis of 2008/2009. The bond market has been driven by inflation, or more accurately the lack of it, the last decade. Think of the hundreds of billions of dollars spent to combat the financial crisis and the massive liquidity injections undertaken by central banks around the world. And most large developed countries have consistently fallen short of their inflation targets every year since 2009. Today's economy is structurally very different from the economy of twenty or thirty years ago. Demographic trends and technological changes are but two of many big trends that appear to be driving inflation lower.

**Equity Outlook** – Any way you slice the data, U.S. equities today are on the pricey side, as you can see from the table to the right. The only measure where the market looks cheap is relative to bonds. This is another way of saying that bonds are really expensive. How much of a headwind

How long can this continue? This, ultimately, is the \$64 trillion question for the global economy. Our take is that there is a window for modestly higher inflation over the coming twelve-to-eighteen months. A rebound in global growth at the same time unemployment is at fifty-year lows should translate into faster wage growth and modestly higher inflation. Maybe the Fed hits their 2% inflation target this year, up from 1.6% in November. This isn't much of an increase, but should be

S&P 500 Valuation metric	Current	Historical Percentile
US market Cap/GDP	199%	99 <sup>th</sup>
Price/Book	3.6x	90 <sup>th</sup>
Shiller PE	27.8x	89 <sup>th</sup>
Forward PE	18.4X	88 <sup>th</sup>
Cash Flow Yield	7.2%	85 <sup>th</sup>
Free Cash Flow Yield	4.1%	53 <sup>rd</sup>
S&P Earnings Yield – 10Y Treasury Yield	362bps	28 <sup>th</sup>
<b>Average</b>		<b>76<sup>th</sup></b>

Source: Goldman Sachs Investment Research

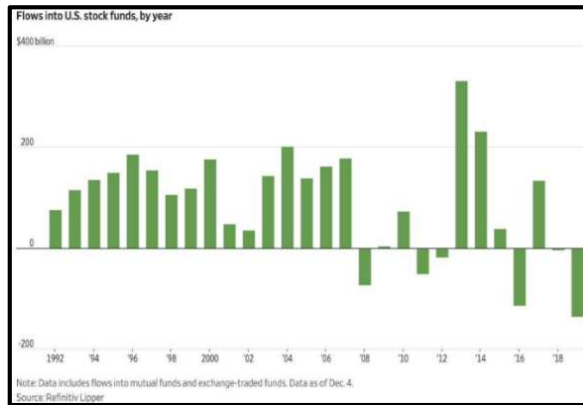


enough to push 10-year Treasury yields above 2% at some point. This won't translate into a bond bear market but simply flat returns after a banner year in 2019. We are keeping the average maturity of our bond portfolios modestly shorter than our benchmarks for the time being, but will use any meaningful increase in rates to extend durations.

**Unresolved Risks** - The global equity market rallied in 2019 due in part to a lessening of political risks. But clearly, they haven't gone away. What happens in Hong Kong this year? Could we see early elections in Germany? Obviously, the impeachment of President Trump is unresolved. On December 18<sup>th</sup> the House voted along party lines to forward two articles of impeachment against the President to the Senate. But for all the drama, the markets are largely discounting the move simply because the Senate is unlikely to take any action that results in removal.

Two issues that we currently know of will probably dominate the headlines this year. The conflict with Iran has gone from simmer mode to boiling mode. How this plays out in the months to come is anyone's guess, but it is worth pointing out that regardless of what happens, the conduit through which it impacts our economy and markets has historically been through oil prices. Typically, rising tensions in the Middle-East directly translated into higher oil prices which hit the economy hard. However, matters have changed significantly in recent years. As you can see from the chart to the right, the U.S. is largely energy independent today. This means any spike in oil prices is unlikely to have a huge impact on the U.S. economy.

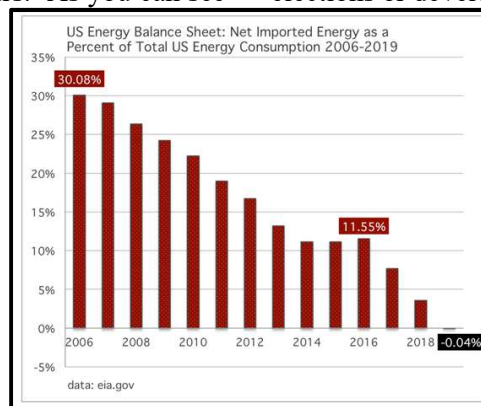
The other major issue is the election. It would be a brave person indeed who would make a large bet on either the election outcome or the market's reaction to that outcome. For what it's worth, we suspect that this time next



year we are looking at more divided government and the market has moved on to worrying about whatever the next hot issue of the day is. Maybe if there is one certainty, it is that polarization will be higher a year from now. The losing side in the upcoming election will have deep heartburn and a crisis of legitimacy could easily haunt the next administration.

**Looking Ahead** – Looking back at 2019 the contrast between the economic and political news and the market performance couldn't be starker. Recession, inverted yield curve, trade wars, etc. etc. But the old saying of never fight the Fed rang true once more!! The question going forward is whether the fundamentals will catch up with the market, or will economic disappointment translate into a meaningful correction or even bear market. We made the case above why we think the fundamentals will improve modestly this year. Certainly, political risks will persist, but critically we don't think we see inflation pick up enough to cause the Fed to start tightening again. This will have to wait until after the election.

After the stellar returns of 2019 we are not going out on much of a limb to predict that returns this year will be much more subdued. Markets have front-run an upturn in the global economy and valuations are a challenge. We aren't bearish, only expecting a much more muted environment with the prospects for heightened volatility due to the elections or developments in the Middle-East (or something that we can't foresee. But the risk of recession remains relatively low and we doubt the monetary backdrop will get contractionary anytime soon. We think investors should ignore the noise again this year and stay the course. Finally, we want to wish everyone a happy and healthy new year.



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