2019
MARKET REVIEW & OUTLOOK

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MARKET OVERVIEW

The year started with the S&P 500 coming off a 13.97% decline in the fourth quarter of 2018.[1] Volatility was the prevailing theme last year, and the trend persisted through much of 2019. As Federal Reserve policy shifted from raising rates to cutting rates and from quantitative tightening to injecting liquidity, global markets generally rebounded from their December 2018 lows (based on indexes reflected on Exhibit 1).

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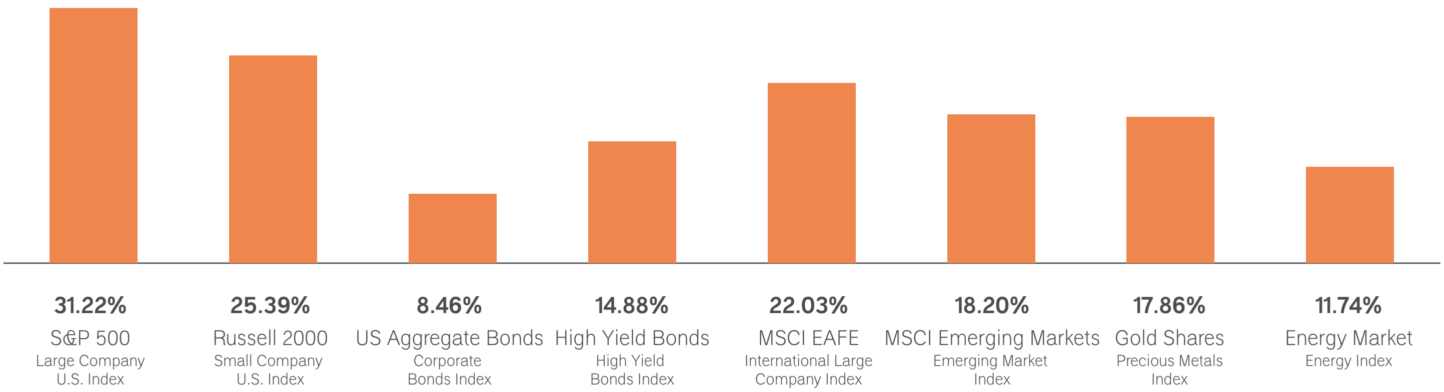
2019 Benchmark Performance

EXHIBIT 1. ASSET CLASS RETURNS*



Source: Morningstar

*The above indexes, year-to-date total returns were found using the following tickers: SPY, IWM, AGG, JNK, EFA, EEM, GLD, and XLE, respectively.

Economic Highlights

We believe the economic landscape in 2019 is best characterized by slow global growth, contracting business investment, declining manufacturing output and exports, and record low unemployment. The current expansion is now in its 11th year, the longest in U.S. history.[2] Global growth, however, appears to be beginning to slow, creating uncertainty in markets as investors anticipate a recession. Factors such as population demographics, business investment, tariffs, and Brexit accentuate the global slowdown.

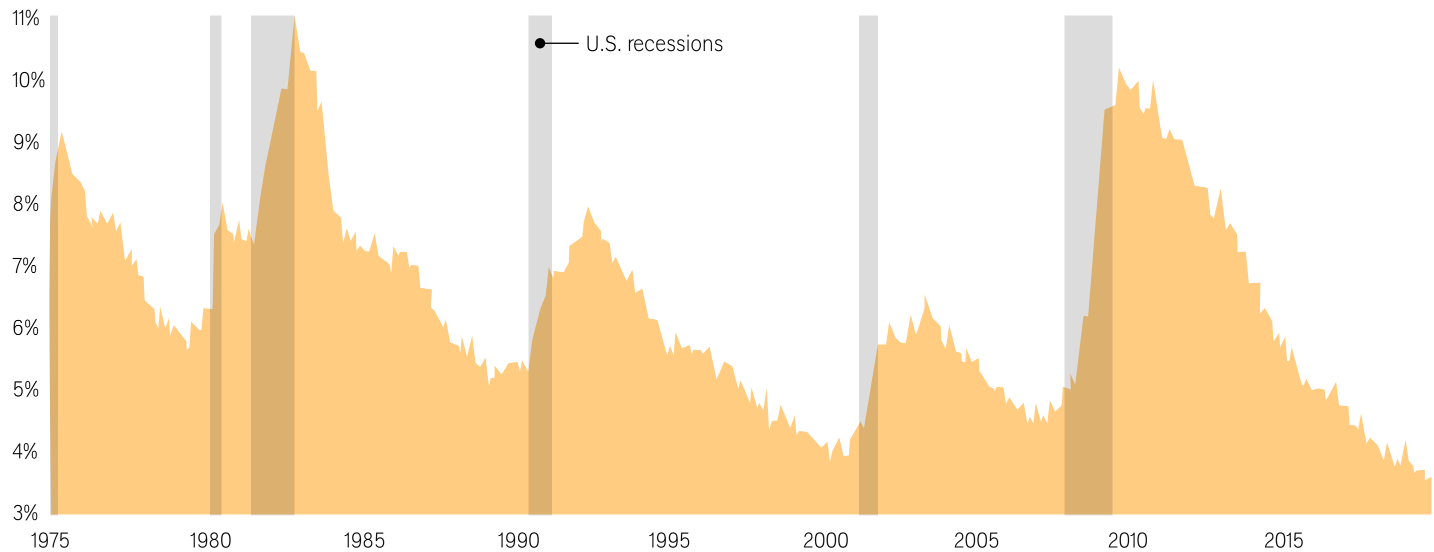
Declining business investment affects the productivity of companies and restricts their ability to expand. One factor influencing business investment is consumer confidence, which was volatile throughout the year as investors grew increasingly worried about an imminent recession.[3] However, according to Jerome Powell, Chairman of the Federal Reserve, the overall economy has been and is expected to continue growing moderately, thanks to a strong household sector and supportive monetary and financial conditions.[4]

Manufacturing output and exports declined for most of 2019. According to the International Monetary Fund, people are concerned that a smaller manufacturing sector implies slower economic growth and fewer well-paying jobs for low- and middle-skilled workers—contributing to worsening inequality.[5] We saw a 6% decline in exports, due largely to the implementation of tariffs that continued to weigh on the global economy as a whole.[6]

The U.S. unemployment rate has been near all-time lows for more than a year (see Exhibit 2). According to the Federal Reserve, wages have been increasing for lower-earning workers, and the job market is expected to remain strong moving forward.[7]

Unemployment Rate over the Past 40 Years

EXHIBIT 2: U.S. UNEMPLOYMENT RATE



Source: U.S. Bureau of Labor Statistics, fred.stlouisfed.org.

Monetary Policy

Federal Reserve Chairman Jerome Powell has completely reversed course on interest rate hikes and balance sheet reductions. Before the market headwinds and heightened volatility of late 2018, the Fed had signaled rate increases of another 0.5%. Powell stated in November 2018 that the Fed "had a distance to go before it would stop raising rates and reducing the balance sheet."[8]

However, Fed statements and actions now suggest it plans to "act as appropriate to sustain the expansion."[9] In addition to pausing rate hikes and starting to actually cut rates, the Fed announced it would stop reducing the number of bonds held on its balance sheet by September. This year, the Fed cut rates three times, resulting in the federal funds rate hovering between 1.5% and 1.75%.[10]

On September 17, the overnight repo rate spiked to 10%, up from roughly 2% just one week earlier.[11] Repo is short for repurchase agreement. Basically, this market exists to provide short-term collateralized loans, often made overnight. The rate spike appears to have been caused by short-term liquidity issues. In response, the Fed injected $75 billion a day for four consecutive days, which brought the overnight repo rate back into its target range.[10]

Injecting liquidity into markets, expanding the Fed's balance sheet, and cutting rates are all actions that normally would be taken in a recessionary environment, which doesn't exist today. The concern here is that by making moves now to sustain the expansion, the Fed will not have many options left when a recession eventually arrives.

Geopolitics

U.S.-China Trade War

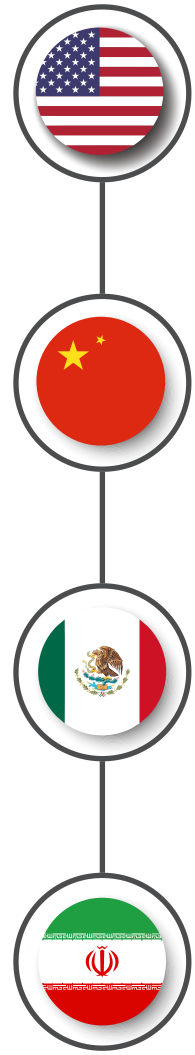
Market growth slowed in the second quarter of 2019 amid a renewed flare-up in tensions between the U.S. and China. In February, following successful talks between the two countries, President Trump agreed to extend the March 1 deadline to finalize a trade deal.[12] Despite "progress,"[13] however, the U.S. increased tariffs[12] to 25% on $200 billion of Chinese goods in May. One month later, China retaliated by raising tariffs[14] to as high as 25% on $60 billion of U.S. goods. Following positive discussions between presidents Trump and Xi at the G-20 summit in Japan, the U.S. and China agreed to resume trade negotiations and suspend the implementation of new tariffs.[15]

However, the truce was short-lived. After trade talks in Shanghai on July 30 and 31, President Trump announced plans to increase tariffs by 10% on the final $300 billion of Chinese imports, beginning September 1. The move was due, in part, to allegations that China failed to purchase U.S. agricultural products in the amount agreed upon as a condition of the truce.[16] On August 5, the U.S. Treasury Department declared China a currency manipulator, citing their "...long history of facilitating an undervalued currency through protracted, large-scale intervention in the foreign exchange market."[17] China responded by announcing tariffs on $75 billion of U.S. goods.[18] After another round of successful talks, the U.S. and China agreed to a Phase One deal on December 13; however, details of the deal remain unclear.[19]

Mexico Tariffs

In May, President Trump announced his intention to raise tariffs on Mexican goods. The plan was to increase tariffs 5% every month beginning in June, up to a cap of 25%, if Mexico failed to stop illegal immigration at the southern border.[20] On June 7, the U.S. withdrew its plan after reaching a deal with Mexico on immigration.[20]

At a September 6 news conference, Mexico's Foreign Secretary, Marcelo Ebrard, stated that the number of undocumented migrants crossing through Mexico to the U.S. border declined by 56% between May and August.[21] As a result, Mexico does not expect any threats of tariffs from the U.S. in the near future.[21]



Other Tariffs

On December 2, President Trump stated that tariffs on steel and aluminum imports from Brazil and Argentina would be restored, effective immediately, alleging devaluation of each country's currency.[22] That same day, the U.S. announced the possibility of implementing tariffs of 100% on imported French champagne, handbags, cheese, and various other products if France's digital services tax is implemented.[23] The U.S. alleged that such a tax would unfairly harm U.S. tech companies.[23]

U.S.-Iran Political Relations

The deterioration of U.S.-Iran relations accelerated in the second quarter, apparently triggering much of the volatility in global oil markets. In April, the U.S. announced it would end sanction exemptions for eight countries buying oil from Iran—an attempt to reduce to zero Iran's oil exports, its largest revenue source.[24] In response, Iran allegedly attacked six oil tankers in the Persian Gulf[25] and shot down a U.S. surveillance drone near the Strait of Hormuz.[21] On September 14, multiple oil facilities in Saudi Arabia were attacked.[26] The Houthi group in Yemen claimed responsibility, but multiple countries allege that Iran was behind the attacks.[26] The U.S. and several other nations responded with sanctions on 25 targets linked with Iran's support of militant networks throughout the world.[27]

Macroeconomic Headwinds

Breakdown of Global Trade Structure

The World Trade Organization's dispute system is officially broken. The WTO's Appellate Body, which decides appeals of decisions made by trade arbitration panels, is now down to one judge after two other judges' terms expired on December 10, 2019.[28] Since former President George W. Bush was elected to office, the U.S. has continuously vetoed the appointment or reappointment of any new judges, due to what it perceives as a broken system.[28] Without the three-judge panel required to make decisions, all appeals are in limbo for the foreseeable future, crippling the WTO's attempt to curtail unwarranted trade protectionism.[28]

WORLD TRADE ORGANIZATION

This breakdown of the WTO's dispute system effectively mirrors the growing global shift toward more protectionist trade policies aimed at shielding domestic industries from unfair foreign competition. Specifically, the U.S.'s implementation of tariffs on global imports—a protectionist trade policy—is beginning to spread beyond China to the European Union, Brazil, Argentina, and India.[29,30,31] Any further implementation of tariffs on other countries may result in a greater-than-expected decline in global trade, which may indirectly cause a slowdown in the U.S. economy.

Growing Debt

According to the International Monetary Fund, the rate at which U.S. debt is expected to grow relative to GDP between 2019 and 2024 will outpace all other advanced economies.[32] This is especially concerning with unemployment at an all-time low, inflation stable, and U.S. growth expectations lagging. The U.S. economy is projected to grow 2.4% in 2019 and 2.1% in 2020—well below projections of 3% and 3.4% growth for the global economy in those same years.[32]

Without a plan to reverse spending, the current growth rate of U.S. debt to GDP increases downside risk in the event of an economic downturn.[32] Additionally, the U.S. economy faces other debt risks beyond growing government spending, including the rise of sub-prime auto loans and student debt.

Top-Heavy Population Demographics

Perhaps the biggest threats to future growth in the global economy are the top-heavy population age demographics of many developed countries, combined with declining birthrates.[33,34] In the U.S., the baby boomer generation makes up about 25%[35] of the population, with the majority expected to be retired by 2022.[36] The largest living adult generation[35] is leaving the workforce and taking their accumulated capital with them. At the same time, birthrates are declining and trade policies are becoming increasingly protectionist. Together, they pose the risk of a prolonged slowdown due to labor shortages, drastic increases in the cost of capital, and the inability to grow the U.S. economy using other countries' resources.

THE LARGEST LIVING ADULT GENERATION IS LEAVING THE WORKFORCE AND TAKING THEIR ACCUMULATED CAPITAL WITH THEM. AT THE SAME TIME, BIRTHRATES ARE DECLINING AND TRADE POLICIES ARE BECOMING INCREASINGLY PROTECTIONIST.

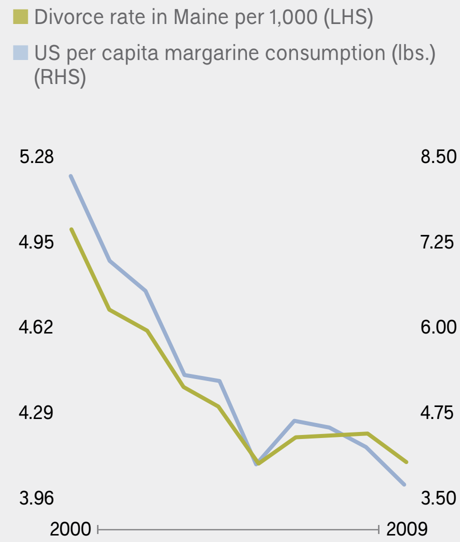
Diverse Ideologies

There is much talk in the business media about possible market reactions if a new candidate gets elected to the Oval Office. Historically, elections have had "no direct causal connection."[37] While some interesting correlations can be found, correlation does not imply causation. For example, the divorce rates in Maine are highly correlated to margarine consumption (chart right). While these variables have no economic or causal relationship, they share a 99% correlation coefficient.

Although the U.S. presidential election itself has yet to dictate what its markets have done, the policies implemented while a president is in office will have positive or negative effects. Healthcare, Social Security, Medicare, Modern Monetary Theory, and wealth tax changes could have large impacts on the economy. No matter your political views, this is a scenario that we continue to monitor as we invest carefully over the current market cycle.

DIVORCE RATES IN MAINE CORRELATE TO MARGARINE CONSUMPTION

CORRELATION: 99.26% (R=0.992558)



Sources: Spurious Correlations (tylervigen.com) for National Vital Statistics reports and US Department of Agriculture, as of 12/31/09.

Technological Advancements

Despite all of the above challenges, the world continues to make technological advancements in many different industries, forging new pathways to innovations, products, and processes. Here are some of the more significant recent developments that may continue to shape our future over the coming decades.

5G

5G is the fifth-generation of cellular wireless technology. With its faster data speeds, lower latency, and ability to connect more devices, 5G has the potential to provide a number of benefits to society. It could, for example, have a major impact on the medical industry. Surgeons would be able to control devices like the da Vinci machine from a distance, giving the world access to the best care regardless of location.

5G also has many implications for autonomous vehicles that need to make decisions quickly. With 5G's low latency properties, autonomous vehicles can communicate and share information with each other in almost real-time, resulting in better decisions and improved safety.

Blockchain

Blockchain technology, originally devised for Bitcoin, is finding potential uses beyond digital currency. Simply put, blockchain allows digital information to be distributed, but not copied. The benefit to users is better security than other alternatives employed today. A blockchain network cannot be controlled by any single entity and has no single point of failure. Because information is distributed among millions of computers instead of centralized in one location, a single point cannot be manipulated to change the integrity of a transaction. This technology is still in its infancy, but the implications are significant for transaction-based industries.

In 2019, blockchain began to emerge from its early stages as companies took advantage of the many benefits. The technology is allowing all parties to view up-to-date information for logistics and supply chains. It is also safeguarding consumer online purchase history, improving the performance of artificial intelligence, and securely managing health records.

3D Printing

3D printing has come a long way from its first patent in 1984, which was focused on making prototypes for industrial and engineering use.[38] Nowadays, 3D printing is used in fields ranging from medical to space exploration, and some hope to bring it to the food industry in the near future.

When it comes to space exploration, the International Space Station has a 3D printer aboard to print parts needed for maintenance. In healthcare, 3D printers are already being used to print implants as well as prosthetics.[39] Also, life-size anatomic models are being printed and used in mock surgeries to train young surgeons.[40] One of the more significant breakthroughs occurred when a team of Israeli scientists successfully printed a tiny live human heart from tissue taken from a patient—in just three to four hours.[41] The use of 3D printing in the medical field has already provided a number of benefits and is considered to be in the early phase of its development.

Artificial Intelligence

Artificial intelligence (AI) continued making great strides in 2019. Throughout the year, we witnessed many breakthroughs, but one in particular stood out to us—the use of AI to detect false news. Before 2019, companies such as the Washington Post began using AI-based algorithms to write news articles, allowing more content to be delivered to target audiences faster than ever.[42] However, the technology wasn't without its drawbacks. AI-based algorithms can also be used to generate false news articles, and it is becoming increasingly harder to differentiate those stories from the truth as well as human-generated content.[43] To help combat this problem, researchers at the University of Waterloo (UOW) and the Allen Institute for AI (AI2) developed new algorithms.

UOW's tool uses deep-learning AI algorithms to determine whether the information in an article, post, or story is supported by other content on the same subject.[44] Researchers claim the new technology can correctly verify content nine out of 10 times.[44]

GROVER, an AI-based model developed by AI2, can determine whether select content was created by a human or AI.[45] GROVER analyzes and learns from self-generated content as well as content produced by similar AI models, allowing it to differentiate human- and machine-written content with 92% accuracy.[45]

Although none of these AI-based algorithms can completely eradicate the spread of false information at this time, each provides a crucial building block as society moves toward that goal.

Conclusion

Market environments like the current one may entice investors to stray from market fundamentals or their investment discipline. As always, we find it important to resist the temptation of performance chasing and the behavioral mistakes of market timing. While the debt music continues to play globally, we want to make sure we have a chair when it stops—and it historically has always stopped.

1 https://www.cnbc.com/2018/12/31/stock-market-wall-street-stocks-eye-us-china-trade-talks.html
2 https://www.cnbc.com/2019/07/02/this-is-now-the-longest-us-economic-expansion-in-history.html
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