SlateStone WEALTH

Balancing Your Life Goals with Financial Results

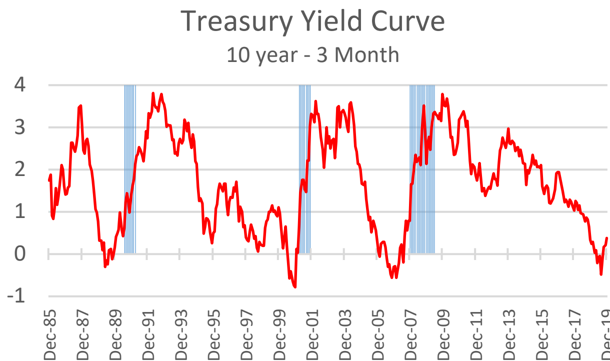
Investment Review & Outlook

January 2020

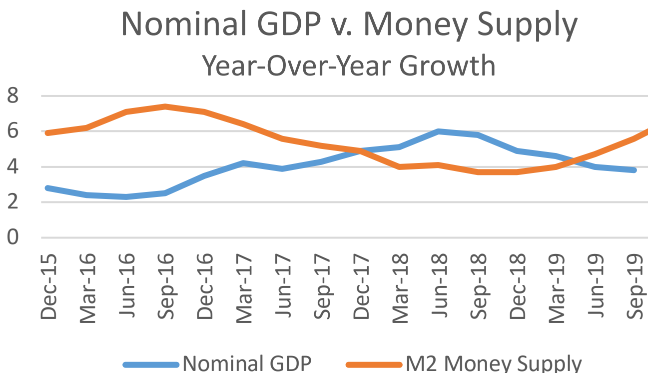
Review

Equity markets around the world were surprisingly strong in 2019. Beginning the year with a particularly strong first quarter, followed by a slight pause through the Summer months only to end the year on a new high.

Our concerns regarding the "inverted yield curve" have not been realized. Perhaps it has been a function of how we "inverted." Prior inversions were a result of the Federal Reserve driving short-term interest rates higher with the intent of slowing the economy and curbing inflation. This most recent inversion arose as longer-term interest rates fell more than short-term rates in early 2019. In recent months, the Treasury Yield Curve has returned to "normal" with no recession in sight.



To offset the recession threat implied in an inversion, the Fed has opened the flood gates on the money supply, joining the rest of the developed world's central banks. At this point, all of them would welcome an uptick in the rate of inflation, particularly wage inflation. But, let's not forget Milton Friedman's cautionary quote that "inflation is always and everywhere a monetary phenomenon."



Data sources: Standardandpoors.com, Bloomberg, MSCI.com *Continued on page 2*

Global Markets

The S&P 500 Index increased a remarkable 31.5% on a total return basis in 2019, following a 13.5% drop in the fourth quarter of 2018. All the world's equity markets were up substantially last year. Within the S&P 500, Technology, Communication Services and Financials outperformed. The weakest sectors were Health Care and Energy. Energy was a substantial drag on the overall index with a relatively modest 11.8% gain.

Treasury Notes with 3 to 5-year maturities generated a 5.3% return in 2019.

The US Dollar, as measured by a basket of major currencies, rose in a choppy fashion though the first nine months of last year, but sold-off a bit as the year approached its close.

Equity Market Performance
To 31-Dec-2019, in US Dollars

	4th Quarter 2019	12 Months 12/31/19
MSCI World Index	8.6%	27.7%
Europe	8.8%	23.8%
France	8.5%	25.7%
Germany	9.9%	20.8%
Switzerland	7.6%	32.3%
United Kingdom	10.0%	21.1%
Japan	7.6%	19.6%
Pacific, ex Japan	5.8%	18.4%
EAFE	8.2%	22.0%
USA	9.0%	30.9%
Emerging Markets	11.8%	18.4%

Source: Morgan Stanley Capital International,
Total return, dividends less withholding tax reinvested

.

Continued from page 1

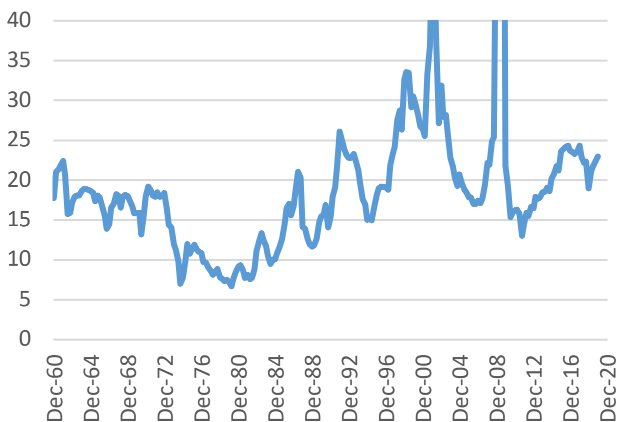
Outlook

We certainly experienced asset price inflation in 2019 with share prices increasing 29%, while earnings for the S&P 500 were essentially flat over the first nine months of the year. Consensus economic growth expectations show a slowing annual rate of growth in 2019 and slower still in 2020. The money supply growth must go somewhere, if there is an absence of demand in the "real" economy, then it will flow into financial assets.

Real GDP Growth - YoY %				**Market P/E**
	2018	2019	2020	6-Jan-20
US / S&P 500	2.9	2.3	1.8	21.6
Eurozone / Stoxx 600	1.9	1.2	1.0	20.8
UK / FTSE 100	1.3	1.3	1.0	18.4
China / CSI 300	6.6	6.1	5.9	14.7
Japan / Nikkei 225	0.3	0.9	0.3	18.8

Source: Bloomberg, January 6, 2020

Equity market valuations are high, but not unprecedented. We experienced more than a decade of relatively high Price / Earnings valuations in the 1960's, a period characterized by similarly low rates of inflation.



Eventually market valuations (Price / Earnings) were brought down by rising rates of inflation in the 1970's and 1980's. We do not see that recurring anytime soon but intend to keep an eye on wage inflation as we move forward. The immediate problem is that we have a difficult time reconciling slowing economic growth, both in the US and around the world, with sharply higher earnings expectations.

There are several sources for earnings data available. You would hope that they would be consistent, but they are not. Some of the differences are explainable, for example, whether the data include non-recurring items, but significant variances remain. We use reported earnings data from the Standard & Poor's web site in the table below which results in a higher Price / Earnings number than shown in the Bloomberg data as indicated in the chart to the left.

Standard & Poor's 500				
	Annual Earnings	%Change Y-o-Y	Price/ Earnings	Year-end Price
Dec-12	86.51	-0.5%	16.5	1426.19
Dec-13	100.20	15.8%	18.5	1848.36
Dec-14	102.31	2.1%	20.1	2058.90
Dec-15	86.53	-15.4%	23.6	2043.94
Dec-16	94.55	9.3%	23.7	2238.83
Dec-17	109.88	16.2%	24.3	2673.61
Dec-18	132.39	20.5%	18.9	2506.85
Dec-19e	140.45	6.1%	23.0	3230.78
Dec-20e	161.86	15.2%	20.7	3350

Source: Standardandpoors.com January 5, 2020

It seems quite a stretch for S&P 500 earnings growth to more than double in the eleventh year of an economic expansion (absent another round of tax cuts), while the US and the rest of the world's economic growth is slowing. We suspect that it is a function of the analyst community raising earnings estimates and price targets in response to rising share prices.

We are using 3350 for our price target for the S&P 500 at year-end 2020. Implicit in that estimate is the consensus $161.86 in annual earnings estimates even though we suspect they turn out to be too high. We offset what we expect is an elevated earnings expectation by shrinking the market Price / Earnings ratio to just under 21 times earnings. We continue to favor the health care and energy sectors, two of the under-preforming groups in 2019.

On the fixed-income side, we use bonds in balanced portfolios to mitigate the risk inherent in equity investing and to provide liquidity for unanticipated expenses. We will continue to be very conservative in our bond investments. However when the yield curve begins to "steepen" there may be an opportunity to increase income levels through extending our average maturity.

Jupiter, FL

January 2020

(800) 773 9282