AMB Newsletter
1st Quarter 2020

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Fourth Quarter 2019 Review

The year 2019 is in the books and it was prosperous for asset classes across the board. Equity markets around the globe had strong returns once again led by the US market which posted its best return since 2013. Fixed income markets also thrived as rates fell across the curve leading to strong returns in the credit markets. Asset gains were driven by the Federal Reserve once again as they opened the spicket and increased liquidity and eased financial conditions throughout the year.

US equity markets, measured by the S&P 500, finished the quarter up 9.08%. Technology led the market higher with a return of 14.39% and contributed over 30% of the S&P 500's return for the quarter. Defensive sectors such as consumer staples and utilities trailed as signs of US growth began to pick up. The market ended the year with a total return of 31.49%. Information Technology was the big winner posting a return of 50% with the next closest being financials which returned 32%. Returns for the market were broad based with all eleven sectors of the S&P 500 trading higher on the year.

Developed International markets had a strong year but once again trailed the US. The themes that we have mentioned over the past several years have continued to hinder our foreign counterparts. International markets continued to be plagued by sluggish growth with the fact they are more susceptible to trade disputes and increased protectionism policy from other countries. They also lack the key factor that has driven our markets higher over the past decade which are the innovative tech behemoths that have been responsible for an outsized portion of the returns here in the US.

Emerging markets posted a solid double digit return for the year but once again fell below the returns of the US markets. We do not expect emerging market strength to occur until we begin to see a real weakness in the US dollar or unless growth around the globe starts to show signs of life. Emerging markets are currently tied to US/China trade relations. If we see steady trade progress, we expect emerging markets to have an outsized year. Going into 2020, emerging markets have the best risk/return profile in our view, and we believe this will be the year they have the potential to outperform US markets as long as we do not enter a global recession or see a deterioration in global trade relations.

Fixed income markets had a great year and posted solid returns around the globe. These returns were driven by three federal reserve rate cuts and continued worries over an economic slowdown across the globe which drove monies and interest rates lower. This year was a little unusual as both credit markets and yield markets traded higher. The Fed and worries over a global slowdown drove yields lower and the chase for higher yields led to the performance from credit. We would not expect to see this happen in 2020.

1st Quarter Outlook

Economy (Global)

Last year, we correctly stated that fears of an imminent recession were overblown and that growth in the US would remain relatively strong. The US is going to post 2% plus GDP growth for 2019, and macro releases are pointing to no surprises in the 4th quarter release. We will be entering the 11th year of this cycle, and we expect the expansion to carry through 2020. With the most recent data surprising to the downside, we have seen our belief realized that we are in the late stages of the current cycle. Even though we are beginning to see warning signs, our key indicators remain stable. Financial conditions remain accommodative and inflation has remained subdued as confirmed in the recent PMI releases.

Wage growth will remain a key indicator in 2020. With 70% of the US economy comprised of consumer spending, this metric is our favorite for obvious reasons. Recent releases show that wage growth has yet to accelerate, posting year over year growth of just 3.5%. This continues to point to slack in the labor market even with the unemployment levels being at historic lows. Without upward pressure on wages, the Federal Reserve will continue to have leeway to loosen financial conditions further if the economy begins to falter. If we begin to see an uptick in wages, our outlook will change.

Our views on China and its overall impact on the global economy have not changed since our last letter. The main focus for the global economy should remain on China as it has contributed approximately one-third to global growth over the past eight years. Starting in 2018, China's slowing growth has been a drag on the global growth story, which was brought on by increased trade conflicts with the US and tighter domestic policy. Both of these issues appear to be improving. Trade negotiations are progressing between the two global economic powers, evidenced by the phase 1 trade deal, after talks seemed to fall through in the second quarter of 2019. Financial conditions continue to be easy as the PBOC injects liquidity into their financial institutions. We believe trade talks will continue to progress throughout 2020. One positive catalyst that has taken place that will ease pressure on China and the rest of the emerging economies is the pivot from the US Federal Reserve. Moving from a rate hiking cycle to a rate cutting cycle should help with capital flow issues and dollar strength both of which have hindered the growth of emerging markets.

As always, Central Bank monetary policy will continue to play a role in our economic projections as their role in the global economies continues to expand. Their actions have a direct impact on the money supply which can either promote or hamper growth. The US Federal Reserve has moved to full on easing and is expected to cut rates at least one more time this year. The ECB has taken their benchmark rate further into negative territory and restarted their bond buying program. The BOJ never stopped easing and will up the ante if they feel it is needed. All of that to say, world central banks are all in on delaying or averting the next global economic downturn. Our models and projections on future expectations will hinge on the moves these Central Banks make in the future.

As we move forward, our thoughts have not wavered, global economic growth will continue through 2020. Current expectations are for 3% growth; but with a trade deal, expectations would increase as it may provide the bump China needs to restart growth. If this happens, we could easily see 3.4% this year and our expectations for 2021 would increase as well.

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US Equity Market

US Equity markets, measured by the S&P 500, turned in another positive quarter, posting a return of 9.08%. This marked the best year for the S&P 500 since 2013 with a return of 31.49% for the year. After the struggles of 2018, 2019 was a welcomed sight for equity investors. The move last year was driven by the overreaction in the fourth quarter of 2018. The market was pricing in an imminent recession, and as we predicted many times, this did not take place. Because economic conditions were much better than expected, markets had to be repriced once again and this was to the upside for equity investors.

Last year's move was driven 100% by multiple expansion as earnings growth for the market was essentially flat year over year. We do not believe this is sustainable. The US markets will need earnings growth to pick up in 2020 to justify the valuations the market is currently sporting. We believe this will happen as comps will be easier to beat this year. We expect that earnings may have bottomed in the fourth quarter of this year and that we will once again see an acceleration in earnings growth in the first quarter of this year. There are risks to this outlook which include a re-escalation of the trade war and unrest in the middle east. The US is also facing an election year; and depending on the outcome, this could have a major impact on the market.

Looking ahead, the short term holds plenty of uncertainty. We expect the market to be volatile and headline driven from now through the election. A tailwind that we see is profit growth accelerating this year. We are expecting strong single digit growth through 2020. With interest rates remaining low we think the current multiple on the market is justified. In our view, if we see high single digit profit growth, we should see high single digit growth in the overall market. Putting our PT for S&P 500 year-end at 3400-3500.

Here at AMB, we believe in investing for the long term to reach your long-term financial goals. It is impossible to judge quarter to quarter market fluctuations ,but for now, our "longer term" fundamental view of the equity markets remains intact. We continue to believe we are in a secular bull market. Trade spats and other crosscurrents will put earnings expectation and global growth in flux. Because of these ongoing issues, we believe quality companies with strong balance sheets and free cash flow are where we need to be positioned.

Equity markets had a great year in 2019, and we expect another good year in 2020. We believe international markets are currently trading a better valuation than their US counterparts. However, those international markets are facing significant headwinds as we enter 2020 and we believe they are trading cheap for a reason. Until a clearer path with trade tensions and geopolitical unrest the US Equity Markets remain our top pick.

US Fixed Income

We saw a major shift in policy from the Federal Reserve in 2019. The US Federal Reserve changed course and started an easing cycle even if they do not want to call it that. As a panic hit the markets at the end of 2018, Fed Chairman Powell calmed markets with a dovish pivot. Since that time, the FOMC has cut interest rates three times, stopped the balance sheet runoff of assets, and created a standing repo facility (QE light). With the US economy still growing at a respectable rate and unemployment at historic lows, the Fed had to change from its data dependent mantra and take a more global outlook.

In their last meeting, the FOMC announced that they would be on hold for the foreseeable future and did not expect any rate adjustments up or down in 2020. They have also hinted at the fact that if inflation began to increase in the future, they may let it run hot instead of tighten to slow it. This means that if we did begin to see a move higher in rates that was driven by higher than expected inflation expectations then rates may go higher than analysts' projections before the Fed steps in and begins hiking rates again. However, in our view, the amount of debt burden on the US and global economy is going to stymie out any inflationary fears as debt is deflationary by nature.

US Fixed Income (continued)

Our views heading into 2020 have not changed much from last year. We still believe it is a good time to move out of lower credit and into higher quality names. As we have seen, credit markets flashed warning signs at the end of the fourth quarter and now economic data is flashing yellow. With the massive amount of corporate debt on the books, a major economic downturn could turn ugly quickly. With this in mind, being in higher quality names is prudent. Another major factor is liquidity. If we get into a credit crunch, high yield markets could seize up.

We have moved our stance to neutral from overweight duration. In our view the short to intermediate parts of the curve are where we want to be invested. The long end remains unattractive, as one is not being rewarded for the increased interest rate risk that would be taken. We expect overall interest rates to be volatile throughout the year especially with the increased tensions in the middle east and the on-going trade disputes. The US will remain a safe haven, so any dust ups along the way will push money into our paper and drive our yields lower. We expect rates by the end of the year to be relatively unchanged.

As always, investors should remember why we invest in fixed income. It is not the growth engine of portfolios, yet it brings stability and predictability. When using a buy and hold strategy, interest rate movements are irrelevant as we are investing for a stream of cash flows and the safety of principal (which will be repaid upon maturity as long as the bond is credit worthy). Fixed income provides diversification and stability to an inherently more volatile equity portfolio, and we feel it should play a part in every portfolio in some facet.

Conclusion

Markets across every asset class both domestically and abroad did will in 2019. Heading into 2020, we remain positive on the equity market. We see profit growth in the high single digits; and if multiples hold, we will see high single digit growth in the S&P 500. Fixed income markets had a great year as the yield curve flattened and the Federal Reserve cut interest rates. AMB has been long duration for almost a decade; but with the recent move lower on the long end, we have changed our stance to neutral. We believe high credit and short-term to intermediate-term paper will be the best place to be in 2020. As always, we will be keeping a close eye on economic, geopolitical and fundamental data. Should perceived risk begin to rise, we will take action to position accordingly.

Thank you for the opportunity to help you achieve your financial goals.

Matthew J. Roach, CFA ®

Director of Portfolio Management