CHARTWELL REVIEW

January 2020 **FOURTH QUARTER 2019** *Volume XXVI, Issue No.4*

EXTRAORDINARY

As in, extraordinary quarter, extraordinary year, and extraordinary decade. Looking at Figure 1 there is certainly "a lot of green on the screen." Which makes the only negative (red) data, the medium/long term returns of a diversified commodities index, very interesting.

- The S&P 500 didn't record a single daily pullback more than 1% during the entire 4th quarter. Instead, three Federal Reserve rate cuts between late July and Halloween, together with improved prospects for an initial U.S.-China trade deal, drove a powerful 9% equity market rally that caught many investors off guard;
- U.S. large/mid-cap stocks rode sharp 4th quarter rallies to post one-year returns above 30%, the best return since 2013 and second best since 1999;
- Nearly as important, an 80bps drop in composite US Treasury yields and a 135bps drop in composite US Corporate bond yields combined to help push 1-year US$ investment grade bond returns to 8.7%. High yield bonds added nearly 6% to that number;
- Strong stock and bond returns across nearly all regions pushed globally diversified investment portfolios to a 4.6% fourth quarter return, and a one-year return just north of 20%. That's the best result since 2009, when EM stocks returned 79%, high yield bonds returned 58%, and our globally diversified index portfolio was up 28%.

On the other hand –

- The bond market rally took the year end yield-to-maturity on US Aggregate bonds down to 2.3%, nearly a 20-year low. That number is the best forecast we have of the next 7+ years' returns for conservative investors.
- The massive stock market rally has not been accompanied by much earnings growth. Corporate earnings declined 4% in Q3, and are expected to have grown just 4% in 2019. Thus, the S&P's PE ratio at year-end was 20.4x, up from 16.5x just one year ago.

Figure 1: Index Benchmarks

Market Index	Trailing Returns *				
	4Q 19	**1 Yr**	**3 Yr**	**5 Yr**	**10 Yr**
S&P 500	9.1	31.5	15.3	11.7	13.6
U.S. Top-cap Stocks	9.8	31.8	16.2	12.3	13.7
U.S. Mid-cap Stocks	7.1	30.5	12.1	9.3	13.2
U.S. Small-cap Stocks	9.9	25.5	8.6	8.2	11.8
Non-US Stocks (**EAFE**)	8.2	22.7	10.1	6.2	6.0
Non-US Stocks (**Emerg**)	11.9	18.9	12.0	6.0	4.0
3 mo. T-Bills	0.5	2.3	1.7	1.1	0.6
U.S. Aggregate Bonds	0.2	8.7	4.0	3.1	3.8
High Yield Bonds	2.6	14.4	6.3	6.1	7.5
Global Bonds ($Hdgd)	(0.5)	8.2	4.3	3.6	4.1
Consumer Prices, p.a.	*0.3*	*2.3*	*2.1*	*1.8*	*1.8*
Blmbrg Commodities	4.4	7.7	(0.9)	(4.0)	(4.7)
MSCI World REITS	0.0	26.1	9.7	7.0	9.9
Chartwell 65/35 Global	4.6	20.4	9.9	7.6	8.2

Figure 2: Average Mutual Fund Returns

Fund Category	Trailing Returns *				
	4Q 19	**1 Yr**	**3 Yr**	**5 Yr**	**10 Yr**
U.S. Large-cap	8.5	29.3	13.5	10.1	12.3
U.S. Mid-cap	7.2	27.0	9.5	7.7	11.6
U.S. Small-cap	8.2	23.9	6.9	7.4	11.6
International Lg. Cap	9.0	23.1	9.9	5.9	5.8
International Sm. Cap	10.8	24.4	10.9	8.0	9.4
Emerg. Mkt. Equity	10.4	20.4	11.0	5.3	4.2
Balanced/Hybrid	4.7	18.5	8.4	6.2	7.7
General Bond	0.2	15.0	6.2	4.5	6.7
High Yield Bond	2.4	12.9	5.5	5.1	6.6
Hedge Funds, Equity	5.9	13.9	6.2	4.6	4.7

*Annualized trailing returns for periods ending 12/31/19

Chartwell Consulting (USA), LLC
34 Park Street, Montclair, NJ 07042
chartwell@chartwellusa.com
www.chartwellusa.com
Phone (973) 783-2900
Fax (973) 783-2998

Economies, Economics, Prices, and Policy

	12.31.19	12.31.18
CPI - headline, y-o-y	2.3%	1.9%
CPI - core, y-o-y	2.3%	2.2%
Unemployment Rate	3.5%	3.8%
Labor Force (millions)	164.6	163.1
Employed (millions)	158.8	156.8
Employment/Population	61.0%	60.6%
Growth in Real GDP, (y-o-y)	2.1%	2.9%

At 2.3%, *core* inflation (ex-food & energy) was a little higher during the last twelve months than in 2018. Rising average energy and food prices pushed year-over-year *headline* inflation up to 2.3%. The inflation rate fell back to only 1% in the third quarter, and then to a very low 0.1% in the fourth. Unemployment rates remain anchored at 50-year lows, as 2.0 million more people are employed than a year ago; the labor force grew by 1.5 million persons and the employment-population ratio is trending upward.

Figure 3: Breaking Down 3rd Quarter Real GDP*

% Change from Preceding Period *(seasonally adjusted at annualized rates)*

Factor	3Q '19	2Q '19	1Q '19	4Q '18
Real GDP Growth	2.1%	2.0%	3.1%	1.1%
Nominal GDP Growth	3.8	4.7	3.9	2.9
Real Final Sales	2.1	3.0	2.6	1.0
Personal Spending	3.2	4.6	1.1	1.4
Private Investment	(1.0)	(6.3)	6.2	3.0
- Fixed, Businesses	(2.3)	(1.0)	4.4	4.8
- Fixed, Residential	4.6	(3.0)	(1.0)	(4.7)
*- Chg. In Inventories **($bn)***	*$67*	*$75*	*$113*	*$100*
Export growth	1.0	(5.7)	4.1	1.5
Import growth	1.8	0.0	(1.5)	3.5
Government Spending	1.7	4.8	(0.4)	2.1

** BEA final estimate on 12.20.19*

The low 2.1% annualized increase in real GDP during Q3 was paced by the positive contribution from personal spending. It effectively accounted for all of the 2.1% change. Goods and services (housing) spending growth were equal contributors. Increased housing investment and government spending (especially at the federal level) helped to offset weaker business fixed investment and net exports.

The current model estimate for real GDP growth in the fourth quarter of 2019 is 2.3%. This figure has steadily risen from a very weak 0.5% in mid-November. Higher November durable manufacturing, new housing starts, and existing home sales, together with stronger than expected December construction spending reports, have boosted estimates. The *Blue Chip* consensus estimate is 2.0%.

Businesses continued to hire during the fourth quarter, at a slightly increased pace compared to the third. Payroll jobs rose by 553k, compared to 470k in the 4th quarter. The household employment survey reported a similar 543k employment increase. The index of average weekly payrolls is up only 2.3% versus one year ago – level with inflation.

Inflation rates in Q4 rose modestly compared to Q3 -

⇒ "Headline" CPI rose just 0.08%, or an annualized rate of just 0.3%.

⇒ "Core" CPI (*ex-food & energy*) rose 0.7% annualized during the quarter, and 2.3% over the past year.

⇒ The Producer Price Index for final demand *increased* 0.4% in October, due to a cumulative 4% increase in food and energy costs. The index was effectively flat through the rest of the quarter. As a result, the PPI final demand index for goods and services advanced just 1.3% for the 12 months ended in December.

On the monetary policy front, the Federal Reserve once again lowered its target Fed Funds rate during the quarter, dropping it on October 31st to the 1.50-1.75% range. That made three 25bps reductions in 2019, bringing the target range back to its March 22, 2018 level.

In late September, interest rates for repo agreements — essentially short-term loans between banks and other financial institutions — spiked briefly to 10%. The run-up spilled over into money markets, pushing the Fed's policy rate temporarily above the range that policymakers were targeting. In early October, the Fed quickly unveiled a new plan to buy Treasury bills thru the second quarter of 2020. By expanding its balance sheet, the Fed will increase the system's supply of bank reserves, which are currency deposits at the central bank. Doing so *should* keep episodes like September's from repeating, by creating a steady supply of dollars. As of year-end, the Fed's balance sheet had risen to $4.2 trillion, up from $3.8 trillion in September. This $400 billion liquidity "dump" is cited as the major factor in the 4th quarter's risk asset rally.

The manufacturing index ended the 3rd quarter on a weak note, down 1% since September 2018. The 4th quarter provided little prospects of a turnaround. New orders for manufactured durable goods dropped 2% in November vs. October, following meager 0.2% growth in October.

On a forward-looking basis the Institute for Supply Management's manufacturing business survey reported the December PMI registered 47.2%. That was below November's already weak 48.1%, and the lowest such reading since June 2009, when it registered 46.3%.

Manufacturing has become a much smaller segment of our economy during the past decade. Nevertheless, the easing of trade tensions between the U.S. and its major trading partners, especially China, is seen as an important element enabling improvement in our prospects for near-term economic growth above the 2% level.

Bonds Complete an Extraordinary Year

In response to more robust risk appetites, global investment-grade credit spreads tightened, sovereign yields broadly rose, and global equities rallied. Meanwhile, central banks remained accommodative, with many generally moving to wait-and-see stances amid signs of a stabilizing macroeconomic environment.

Medium and long term U.S. yields rose in Q4 alongside the broader sell-off in global rates. Developed market yields rose over the quarter as ongoing trade developments and some tentative signs of growth stabilization generally supported risk sentiment. 10-year bond yields in the U.S., Germany, U.K., and Japan all ended the quarter higher, although they still ended the year lower. Those of the U.S. generally having fallen the most. Thus, long-term US Treasuries dropped 4.1% in Q4, but returned nearly 15% for the year.

Accommodative monetary policy and the large supply of negative yielding sovereign bonds globally provided a favorable technical backdrop for investment grade credit. Corporate credit generated a total return of 14.5% in 2019, the best year since 2009, and overall credit spreads to Treasuries have compressed to just over 90 basis points from 153 basis points a year ago.

Global investment grade credit spreads ended the quarter 18 bps tighter, at 92 bps. In the US, BBB credit spreads dropped to 141bps, or 29bps tighter in the quarter. The investment grade sector returned 1.1%, outperforming like-duration treasuries by 1.8%. Credit spreads tightened over the quarter alongside continued central bank support, positive progress in global trade negotiations,4 and reduced concerns around slowing growth.

This quarter, agency MBS benefited from both the interest rate selloff as well as the risk-on sentiment to stage a comeback from underperformance earlier in the year. Despite continued supply and prepayment concerns, agency MBS saw positive relative performance, with excess returns of over 60 basis points, while total return remained strong at 6.7% year to date.

Market conditions were modestly supportive of the ABS market, which delivered modest returns of 4.5% over the year. On a relative basis, the sector outperformed Treasuries by 70 basis points but was unable to match corporate credit performance, lagging by over 580bps.

The Fed's abrupt dovish policy U-turn at the beginning of the year helped not only to mitigate the drag from 2018's tighter financial conditions but also to offset market concerns about U.S. – China trade tensions and a worsening global outlook. Other central banks followed the Fed, leading to a sharp rise in global central bank net asset purchases, which after having reached a post-crisis low of $77 billion earlier this year, are estimated to grow to over $1 trillion in 2020.

Figure 4: Primary Bond Sector Returns (%)

Index	4Q '19	1 Yr	3 Yrs	5 Yrs
US Aggregate Bond index	0.2	8.7	4.0	3.1
US Gov't/Credit: (1-3yrs)	0.6	4.0	2.2	1.5
US Treasury: Long	(4.1)	14.8	7.0	4.1
US TIPS (1-10yrs)	1.0	6.9	2.8	2.4
Mortgage-Backed (MBS)	0.7	6.4	3.3	2.6
Commercial MBS	(0.3)	8.3	4.2	3.4
Asset-Backed (ABS)	0.4	4.5	2.2	2.7
Inv. Grade US Credit	1.1	13.8	5.8	4.4
Leveraged Loans	1.7	9.0	4.7	4.9
US High Yield Credit	2.6	14.4	6.3	6.1
Municipal Bonds, broad	0.7	7.5	4.7	3.5
Global Agg., ($ hdgd)	(0.5)	8.2	4.3	3.6
Global Credit, ($ hdgd)	0.9	12.1	5.6	4.8
Emerg. Mkts Bonds (US$)	1.8	15.0	6.7	6.2

Figure 5: Fixed Income Yields – 4th Quarter 2019

(YTM, % p.a.)	Dec-19	Sep-19	Dec-18	Dec-17	*1-Year Change*
US Treasuries					
3-month	1.55	1.83	2.45	1.39	***(0.90)***
2-year	1.56	1.62	2.5	1.89	***(0.94)***
5-year	1.68	1.55	2.51	2.20	***(0.83)***
10-year	1.91	1.67	2.69	2.41	***(0.78)***
30-year	2.38	2.12	3.02	2.74	***(0.64)***
BarCap Aggregate	2.32	2.27	3.28	2.72	***(0.96)***
BBB Credit	3.20	3.31	4.65	3.59	***(1.45)***
AA Credit	2.37	2.33	3.37	2.70	***(1.00)***
Agency MBS	2.54	2.45	3.39	2.91	***(0.85)***
Emerging Mkts ($)	4.91	5.15	5.95	5.26	***(1.04)***
US High Yield	5.41	5.87	7.95	5.84	***(2.54)***
UST 10yr - 3Mo	0.36	(0.16)	0.24	1.02	***0.12***

Figure 6: Sovereign Bond Yields, selected countries

10-year yields (%)	Dec-19	Sep-19	Dec-18	Dec-17	*1-Year Change*
Switzerland	(0.48)	(0.80)	(0.15)	(0.10)	***(0.33)***
Germany	(0.18)	(0.59)	0.16	0.45	***(0.34)***
Japan	0.00	(0.23)	0.02	0.04	***(0.02)***
Spain	0.44	0.12	1.41	1.50	***(0.97)***
Britain	0.82	0.61	1.34	1.25	***(0.52)***
Italy	1.41	0.87	2.70	2.07	***(1.29)***
Australia	1.43	0.91	2.29	2.68	***(0.86)***
Greece (new bonds)	1.49	1.35	4.40	4.08	***(2.91)***
United States	2.38	1.67	2.69	2.41	***(1.38)***
Poland	2.12	2.02	2.75	3.30	***(0.63)***
China (5 year)	2.83	2.95	2.97	3.88	***(0.14)***
Brazil	4.58	4.92	7.22	8.62	***(2.64)***
Russia	6.40	7.15	8.81	8.13	***(2.41)***
India	6.52	6.69	7.35	7.32	***(0.83)***

US Stocks Trade up, big time

Stocks finished higher in 2019 bolstered by steady, if not spectacular, economic growth. Ten plus years into the current bull run, the S&P 500 index posted record high closings in December. Accommodative central banks, U.S. unemployment at a 50-year low, few signs of inflation and reasonable corporate earnings all contributed to very positive investor sentiment. It wasn't smooth sailing from start to finish, however. Uncertainty around politics and trade ebbed and flowed throughout the year. But in the 4th quarter, everything "ebbed", leading to one of the best quarterly returns in many years.

Following very choppy US equity markets in Q3, the fourth quarter took off. After a sharp, but short-lived, dip of -2.8% through October 8th, the performance chart looks like an escalator. This was especially the case during November and December, following November tweets of an imminent initial trade deal with China (signed on 1/15) and a series of dovish speeches by Fed Reserve leaders following its rate cut on 10/31. The S&P ended the quarter up 9.1% on a total return basis. Before dividends, it was up 8.53%. That is a relatively rare number (extraordinary?), as there have been only 11 better quarters in the past 80.

For the full year, the notable dips were few and the gains were large. We had three sell-offs in the first quarter of 2-2.5% each. May was weak, down 6.8%. The markets lost 6% in July, and 4% during the last weeks of September through October 2nd. That was effectively it. A 14.5% rally in January-February, and a 12% rally during the last two months anchored the 31.5% return.

Figure 7: U.S. Equity Market - Size/Style Returns

		Trailing			
	4Q '19	1-year	3-yrs	5-yrs	10-yrs
Growth					
Large Cap	11.3	36.5	21.4	15.7	15.6
Mid Cap	8.2	35.5	17.4	11.6	14.2
Small Cap	11.4	28.5	12.5	9.3	13.0
Value					
Large Cap	8.0	26.4	10.5	8.7	11.6
Mid Cap	6.4	27.1	8.1	7.6	12.4
Small Cap	8.5	22.4	4.8	7.0	10.6

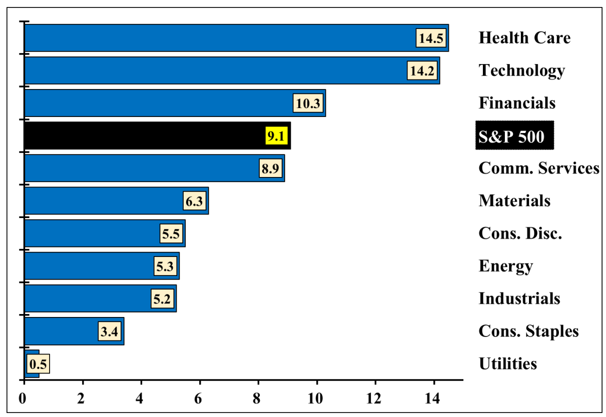
In terms of the size premium, it was not completely evident for the quarter. Midcap stocks underperformed, but this followed strong relative performance earlier in the year. Small cap stocks matched the returns of large caps in both growth and value flavors. The size premium has been completely reversed over the past 3-, 5-, and 10-year trailing periods, with large-cap stocks outperforming over each timeframe. That has not occurred during the past 25 years we've been writing this Review.

In terms of style only, the fourth quarter was an almost classic risk-on market favoring growth stocks over value. The large-cap differential was +3.3% and the small-cap's was +2.9% This contributed majorly to one year positive differential for growth of 8% and 4%, respectively.

Sector return differences in the quarter were once again quite broad, with a 14% spread between "first and worst." After retreating in Q3, large/mid health care stocks rebounded sharply with a 14.5% gain. Big pharma rallied as concerns around drug price transparency and pricing reform died down. Nonetheless, healthcare was a relative underperformer for the year, gaining "just" 21%. Tech stocks followed closely behind, up 14.2%. For the year, tech stocks advanced an extraordinary 50%!

Utilities returned only 0.5% in the quarter, after posting the largest third quarter gains. Utilities stocks were up 26% last year. The year's laggard, by far, were energy stocks, up only 11.8%.

Figure 8: US Sector Returns –4th Quarter 2019



Individual stock contributions were extremely narrowly distributed in 2019. Of the S&P 500's entire 31.5% full-year return, one stock, Apple, accounted for 8.5% of it (i.e, 27% of the total). The other contributors in the top 5 were Microsoft, Alphabet, Amazon, and Facebook. These five stocks contributed over 50% of the 31.5% annual return. The other 495 accounted for the rest. The last time we observed such a noteworthy concentration of the S&P index return was the 4th quarter of 1999.

Drilling down into valuations, large-caps finished the quarter and year with a "next-twelve-months" (NTM) P/E ratio of 18.2x, well above their 20-year average of 15.5x. Earnings growth for the next 12 months is projected to be 9.5%, representing a healthy rebound from 2019 but below their 20-year average.

By way of a heads up – health-care and tech stocks typically suffer their worst performance of the 4-year election cycle in the presidential election year. Financials, energy, and utilities – all value and safety stocks, have had their best average performance in presidential election years.

International Markets Post a Strong Finish

Buoyed by the announcement of a "truce" in the US-China trade dispute and a Brexit-related election in the UK which may increase the likelihood of an orderly withdrawal from the European Union, international stocks finished the year strong. Cyclical sectors led international markets up in Q4 (technology, materials, industrials). Consumer staples stocks were the weakest, followed by utilities and energy. Developed (8.7%) and emerging markets (11.8%) both rallied strongly. Canadian markets advanced "only" 4.9%, but were up 27.5% year to date. All global equity markets finished the year up double-digits, with only emerging markets rising less than 20%. The inclusive All Country World index was up 9% in the fourth quarter and 26.6% for the year.

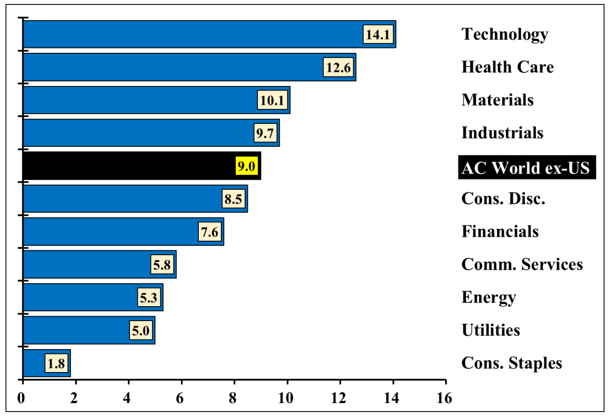
Within developed markets, Europe outperformed the Pacific region for the quarter and the year. Europe rose 8.8% in Q4 and 23.8% for the year. The British pound staged a powerful rally (gaining 7.5% against the US$) after UK voters gave the Conservative Party a commanding majority in Parliament, making it likely that PM Johnson will gain approval for his Brexit plan. The eurozone economy continued to sputter, with annual GDP growth expected to fall to the lowest level since 2013. Irish stocks were the top performers in Q4 (18.5%) and for the year (37.5%). All countries rose double-digits for the year, except for Finland (9.5% annual return).

Figure 9: International Equity Markets – Returns

	U.S. Dollar Returns (%)		Local Currency Returns (%)	
thru 12/31/19	4Q '19	1-Yr	4Q '19	1-Yr
World ex-USA	**7.9**	**22.5**	**5.0**	**21.6**
- MSCI Growth	*8.1*	*27.9*	*5.4*	*27.2*
- MSCI Value	*7.6*	*17.0*	*4.5*	*16.0*
- Europe	8.8	23.8	4.5	23.8
- Pacific, ex-Japan	5.8	18.4	2.6	18.0
- Japan	7.6	19.6	8.2	18.5
- United Kingdom	10.0	21.1	2.3	16.4
Int'l Small Caps	**11.4**	**25.4**	**8.4**	**24.4**
Emerging Mkts	**11.8**	**18.4**	**9.5**	**18.1**
- EM Asia	*12.5*	*19.2*	*10.8*	*19.1*
- EM Europe	*13.1*	*32.3*	*9.4*	*26.7*
- EM Lat Amer	*10.5*	*17.5*	*7.0*	*19.7*
- EM BRIC	*13.1*	*22.8*	*12.0*	*22.7*

The Pacific region rose 7% during the quarter, and gained 19.3% for the year. As the largest country in the region, Japan was a contributor to both Q4 and full year results (7.6% and 19.6%, respectively). Japan's economy expanded despite trade friction. GDP rose 1.8% in Q3, helped by strong consumer spending, which offset a slump in exports and manufacturing.

Figure 10: Ex-USA Sector Returns – 4th Quarter 2019



The euro rose 3% versus the US$ during the quarter, but fell 2% for the full year. The yen declined modestly in Q4, and was the only developed market currency to decline versus the US$ in Q4. Hong Kong's economy fell into recession, as GDP contracted 3.2% following a 0.2% decline in the prior quarter. Months of political protests have hurt business confidence, tourism and retail sales. Global trade tensions continue to be a headwind. Shrugging off the bad news, stocks rose 7% in Q4, representing the bulk of a 10.3% annual return. Australia was the weakest performing country in the region (+4.3%). The central bank cut its policy rate to a record low 0.75%. The economy grew by a modest 0.4% in Q3, as a tax cut and lower interest rates failed to spur household spending. New Zealand was the best performing country in the Pacific region (17.4%), as the economy expanded and the government unveiled an infrastructure spending plan to support growth. Singapore's GDP rose 2.1%. The central bank loosened monetary policy in October for the first time in three years. Stocks rose 7.4%.

Emerging markets (+11.8%) rallied to post their strongest gain in 11 quarters. The "phase one" trade deal between the US and China and a planned rollback of trade tariffs propelled returns. Chinese stocks (+14.7%) rebounded after two consecutive quarterly declines. In addition to the trade truce, Chinese officials pledged to support the economy in 2020 with more fiscal and monetary stimulus. Indian markets rose modestly (5.3%). Economic growth slowed, due in part to a liquidity crunch in the non-bank financial sector, creating a drag on consumer spending. The top performing emerging region was Europe (+13.1% in Q4, 32.3% for the year). Hungary jumped 22%, but the real driver was the much larger Russian market (+16.8%). Top performers included Lukoil, Gazprom and Sberbank. For the year, Russian stocks returned 50%. Latin America was the weakest region in Q4 and for the year (10.5% and 17.5%, respectively). The largest economy, Brazil (14.2%) posted their best quarterly gain since 2017. The economy appears to be heading in the right direction under first-year president Jair Bolsonaro.

Back Page Perspectives

The investment tactics which have recently worked best are pretty clear and simple –

- ⇒ Strongly overweight strategic allocations to US stocks compared to those of the global markets;
- ⇒ overweight "expensive" US stocks versus expensive US and non-US bonds;
- ⇒ emphasize credit bonds with higher yields/risks, versus treasury or sovereign bonds;

2019 represented an historic culmination of this strategy, as it was only the 4th year in the last 94 when US stocks and US bonds together provided such high returns.

Stocks

Among the 23 developed market countries, only one country was a Top 5 performer for 2018 and 2019: the US. Last year's strongest performing market – Finland, ranked 22nd this year.

Outside the US, Greece—the site of an economic crisis so dire some expected the country to abandon the euro earlier this decade, and a country whose equity market lost more than a third of its value last year—has had one of the most robust stock market performances among emerging economies in 2019, up 43% in US$ terms. On top of that, Greece recently issued bonds at a negative nominal yield, which means investors paid for the privilege of lending the government cash.

Bonds

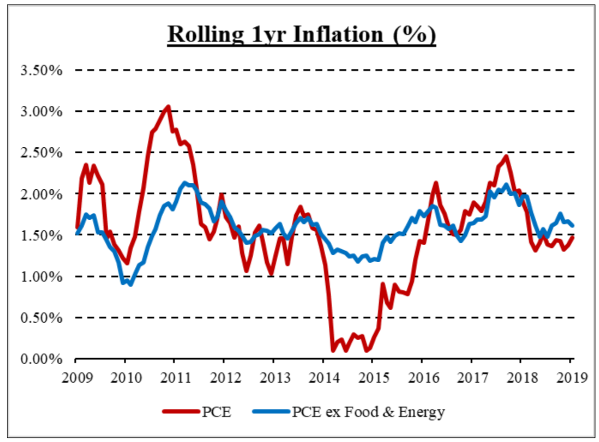
While the Fed's accommodative monetary policy has had the desired effect on nearly all asset prices this cycle, it has also helped facilitate a surge in debt across fixed income markets. At over $10 trillion, nonfinancial corporate debt represents nearly 50% of GDP and has risen by over 52% from the pre-crisis peak of $6.6 trillion. Current market performance should not be confused with improving fundamentals.

Monetary easing and a significant demand for yield has supported an extended rally in the junk bond market, driving returns to over 14% for the year. This has caused HY credit spreads to approach historic lows (below 3%). Hidden inside the robust return number is the fact that investors have largely withdrawn support from the lower quality parts of the market. CCCs lagged BBs for the better part of a year, ultimately trailing by nearly 600bps.

Fundamental credit metrics have also weakened, with high yield gross leverage rising. Specifically, the "tail" in the high yield market (i.e., credits where yield spreads to Treasuries are greater than 1000 basis points) rose from a low of 3% in 2018 to nearly 7% in December.

Taken as a whole, these facts should be a reminder that the prediction game can be a losing one for investors.

A solid proxy for expected annual inflation is its rolling five-year average. We've graphed the Personal Consumption Expenditures index below for the last 20 years. Core inflation has been remarkably constant at well less than 2%. This, despite extraordinarily accommodative fiscal and monetary policies during the past decade. Given those outcomes, we're hard pressed to predict that the next ten years will be much different. If so, "expensive" US bonds are still priced to provide positive real returns.



After a double-digit 10-year return like the '10's produced, it's more likely than not that the next decade will produce single digit equity returns, or worse (the '00's). The exception was the 1990's, because cheap stocks in P/E terms on 12/31/89 (14.5x) became very expensive stocks on 12/31/99 (28.4x). And, earning performance was solid.

Today, all-time highs in equity markets, near all-time lows in bond markets, and a meaningful reduction in yield premiums across credit markets all seem unmoored from fundamentals. Whether or not a recession is on the horizon, growth both in the U.S. and abroad weakened last year. In the near term, trade policies and other related uncertainties continue to weigh on business activity and investment, which does not appear to bode well for near-term future growth prospects.

Yet, history has shown there is no compelling or dependable way to forecast stock and bond movements, and 2019 was a case in point. Rather than basing investment decisions on predictions of which way debt or equity markets are headed, a wiser strategy may be to hold a range of investments that focus on systematic and robust drivers of potential returns. Investors who stay broadly diversified across asset classes and around the globe will be in a position to potentially enjoy the returns that the markets will deliver in the '20's.

Sell high, buy low. See you next quarter!

Natalka Bukalo
Richard Shaffer, CFA

