BTC CAPITAL MANAGEMENT™

Investment Insight

Fourth Quarter | 2019

Economic and Market Overview

Contributed by | Jon Augustine, CFA, Chief Investment Officer

An Impressive Year, A Rewarding Decade

In the classic historical novel written by Charles Dickens, "A Tale of Two Cities," there is an oft quoted line that begins by stating, "It was the best of times, it was the worst of times." This sentiment is an apt description of the decade that ended with the close of 2019. While the U.S. economy delivered positive growth throughout the period and financial markets delivered returns ranging from modest to exceptional depending on asset class, many investors did not seem to enjoy the journey. Their lack of enthusiasm may not translate into a feeling of the worst of times, but it certainly did not reflect a mood indicative of the best of times.

> ***The expectation for the U.S. economy in 2020 is for more of what we have seen throughout this recovery: modest growth, modest inflation and a supportive monetary policy.***

Using perfect hindsight, if we were in the year 2010 and communicated U.S. equity returns, as measured by the Russell 3000 Index, would deliver an annualized return of 13.4% over the next 10 years, it is hard to imagine anyone would not be positively giddy with such a result. Adding in equity markets outside the United States still yielded a return of 8.8%. And given the widely anticipated increase in interest rates and commensurate decline in bond prices that has been in place seemingly forever, a 10-year annualized return of 3.8% from the fixed income markets would also have been enthusiastically received.

So why weren't investors more enamored with the results generated by financial assets in the decade? While we certainly do not hold ourselves to be experts in behavioral psychology, one explanation is the financial wounds from the market decline that occurred during the 2008-2009 recession never fully healed for many investors. This response to the financial crisis of 2007-2008 was supported by the numerous investment strategies and related products that were created as a reaction to the decline in asset values that occurred during the recessionary period, which focused on protecting investors from future market declines. To the extent investors added these strategies to their portfolios, the lower the resulting returns as many of these offerings lagged the returns provided by more traditional offerings. Add in the ever-present geopolitical risk, trade concerns and domestic political strife and a heightened level of apprehension and mental fatigue on the part of investors is easily understood.

Economic Outlook

As previously noted, the last decade was characterized by consistently moderate economic growth. Real GDP never achieved a calendar year growth rate of 3.0%, hitting the 2.9% threshold twice, in 2015 and 2018. As we move forward into the new decade, our outlook is for the moderate rate of economic growth to continue, prolonging the longest period of expansion on record. To quantify, real GDP growth is anticipated to register 1.8% in 2020 according to a survey of economists conducted by Bloomberg. The 2020 outlook from the Federal Reserve is slightly more optimistic with a projection of 2.0% for real GDP.

Globally, GDP is expected to grow 3.4% in 2020. This compares to a more modest level of 3.0% in 2019. This projection, from the International Monetary Fund, is based on an expectation of improvement in numerous emerging market economies while growth is anticipated to be somewhat slower in China and the United States.

The consumer will continue to play a major role in the U.S. economy in 2020. While recent measures of consumer confidence have shown mixed results, overall readings remain historically strong supported by a solid job market, real wage growth and a positive wealth impact from rising stock markets. Quantifying the level of consumer wealth is seen in the increase in household net worth from $71 trillion as of the third quarter of 2007, to an estimated $117 trillion in the fourth quarter of 2019. Also, employment is expected to remain healthy with little change anticipated in the unemployment rate.

Inflation is expected to continue to increase at a modest pace in 2020 with the Core PCE measure registering 1.9%, just under the Federal Reserve's targeted level of 2.0%. Other measures, such as the Consumer Price Index, indicate a more substantial level of inflation and we will be monitoring these indicators closely, as well.

Monetary policy is not anticipated to be an economic headwind in 2020 as the Federal Reserve is currently

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buying $60 billion of Treasury bills monthly to boost bank reserves and ensure sufficient liquidity.

In summary, the expectation for the U.S. economy in 2020 is for more of what we have seen throughout this recovery: modest growth, modest inflation and a supportive monetary policy.

Asset Allocation Review and Outlook

Throughout the fourth quarter, we maintained our asset allocation positioning. Our overweight to equities continued to make a significant contribution to portfolio performance as stocks handily outperformed bonds over the three-month period. Both domestic and international equities turned in strong performances with the Russell 3000 Index of domestic equities returning 9.1% and the MSCI ACWI (ex U.S.) Index of global equities, excluding the United States, returning an almost identical 8.9%. Fixed income performance, as measured by the Bloomberg Barclays Aggregate Bond Index, returned an impressive 8.7% for the year, but as rates rose in the fourth quarter, the three-month return registered a much less robust 0.2%. Highlighting the excellent overall performance achieved as the decade ended is the fact that equity and fixed income markets had the strongest simultaneous gains since 1998.

In addition to the positive returns for the quarter, the investment environment was relatively calm as volatility was subdued throughout the period with the CBOE Market Volatility Index (VIX) beginning at a reading of 16.24 and ending at 13.78. To provide some perspective to these figures, the VIX began 2019 at a level of 25.42.

Currently we are continuing our allocation positioning with its emphasis on overweighting equities relative to bonds and favoring domestic equities over international markets. As always, we continually evaluate our asset allocation positioning to ensure it reflects our convictions regarding the overall investment landscape and the underlying asset classes comprising client portfolios.

Referring once again to text from "A Tale of Two Cities," as we enter 2020 given our current outlook, we are focused more on the environment being a *spring of hope* as opposed to a *winter of despair*. However, given our strong commitment to risk management, we'll keep a warm coat handy. Just in case.

Fixed Income Commentary

Contributed by | Justin Carley, CFA, Managing Director

It's All About the Fed

In 2019, the Federal Reserve (Fed) cut interest rates three times to the current upper bound of 1.75%. Bond yields across all maturities fell as this transpired. The Fed has recently signaled a pause and a high hurdle to move in either direction in their coming meetings. The 10-year Treasury yield ended the year at 1.92%, which was well above the low of 1.46% reached in September.

> ***We think the Fed understands the dilemma and will support markets in a pre-emptive fashion.***

As we move forward in time, we suspect fixed income markets will continue to decouple from the fundamentals. The Fed injected large amounts of money to alleviate repo market issues, and the federal deficit is set to explode in coming years. This comes at a time when foreign governments are buying fewer U.S. Treasury securities at the margin, especially China, driven by trade balance dynamics. How the Fed responds to ballooning deficits is likely one of the largest determinants to near-term market performance. Currently, they appear to be in a "do whatever it takes" mentality, which supports risk assets, helps move inflation higher and is generally supportive of a steepening yield curve. The Fed balance sheet is set to hit new highs in the first half of 2020 if the current pace is maintained.

Given the speed of descent in the scary fourth quarter of 2018 timeframe, the increasing size of the stock market relative to the economy, and comments made by current and former officials, we think the Fed understands the dilemma and will support markets in a pre-emptive fashion.

Same Narrative, Different Facts

From a fundamental standpoint, we were not as bearish on the economy as the headline Institute of Supply Management numbers would suggest, as one of our key corroborating indicators failed to confirm the downside outlook. Recently, some leading indicators suggest a more optimistic global and domestic perspective. This is highlighted by easier financial conditions both domestically and globally. Right now, most forecasters have punted their recession call a couple quarters forward. What happens if we are at the start of cyclical upswing amid a secular growth super-cycle driven by computing power?

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Lastly, we think the inflation narrative offers a skewed risk-reward dynamic. Bond yields fell when the Fed said it required sustained inflation readings to hike interest rates. However, this willingness to tolerate higher inflation is not good for bond holders. Also, the prevailing narrative is such that inflation is nowhere to be found, which seems misplaced given the median Consumer Price Index is up 2.9% versus the prior year. This is a 10-year high and almost one standard deviation above the 20-year average. Global civil unrest has been very high in the last couple of months, which is driven by an inflationary backdrop and not "good" deflation. And lastly, 24 states will raise their minimum wage in 2020.

We are currently underweight duration but think the range of potential returns in 2020 is very high. We are optimistic on corporate bonds as risk assets remain well supported amid a perfect storm of accelerating growth, heavy central bank support and still defensive positioning among fixed income managers. The most likely path for a change in outlook would be if the Fed backs away from support or shows any signs of concern about inflation. We will be closely monitoring developments related to this potential scenario as the year unfolds.

Equity Commentary

Contributed by | Mark Mandziara, Senior Managing Director

What a Difference a Year Makes

Equity returns surprised throughout 2019. For the fourth quarter, domestic equities advanced 9.1%, while foreign equities rose 8.9%, an obvious difference from the prior year.

Recall our fourth quarter 2018 *Investment Insight* where we posited for 2019 that equities "offer[ed] opportunity, albeit within an environment of perceived higher volatility." That said, the calendar year performance of 31.0% and 21.5%, respectively, for domestic and foreign equities exceeded expectations.

The Stage Is Set – or Is It?

Somewhat surprising is the sentiment of strategists, who waver between divergent outlooks. On one hand, strategists may be reluctant to project a bullish outlook given the returns realized during the last decade coupled with a concern for a seemingly overdue correction. And who would blame them, given the duration of the current bull market at 129 months – the longest in history – versus a historical average duration of 54 months?

Then you have strategists who appear confident this current uptrend will continue, albeit with expectations for muted equity returns during 2020. Their rationale includes expectations for slow growth within the United States coupled with the semblance of an upturn in economic regions outside the United States, given continued quantitative easing.

Within the United States, the economy continues to grow, albeit slowly. While earnings growth abated during 2019, corporations continue to be profitable. According to Refinitiv, analysts estimate earnings for 2019 to contract 0.2% year-over-year. While this may give pause to equity investors, note corporations reported earnings that exceeded analyst's estimates for each of the first three quarters of 2019.

Going forward, analysts project positive earnings growth of 9.7% for 2020. As we approach reporting dates, we anticipate revisions by analysts to their quarterly and annual estimates. Recent trends in revisions have been less negative.

Outside the United States, a similar story emerges where analysts anticipate a modest decline of 1.6% in year-over-year earnings growth for 2019, followed by an increase of 6.6% in year-over-year earnings growth for all of 2020.

Valuation, as measured by the Price-to-Earnings (P/E) ratio, continues to be a focal point. The forward P/E for the MSCI USA Index, a broad measure of tradeable float in the United States, is 18.7x estimated earnings versus its historical average of 18.8x. For foreign equities, the forward P/E for the MSCI All-Country World ex USA Index, a broad measure of investable markets outside the United States, is 14.2x versus its historical average of 15.7x.

Going Forward

We remain confident equities offer opportunity. That said, given the divergence of expectations, including other macro-level events (e.g., the upcoming election), we anticipate somewhat higher volatility given uncertainties within both domestic and foreign markets.

We believe our continuously executed disciplined process provides an opportunity for success, specifically within the framework we see going forward. We continue to favor domestic equities over foreign while favoring domestic large cap over small cap. While the forward valuation of domestic large caps may appear fully valued relative to other equity asset classes, we believe investors will continue to focus on this segment given the liquidity associated to domestic large caps.

BTC CAPITAL MANAGEMENT APPROACH:

- Preserve Capital in Difficult Markets
- Make Decisions Based on Fundamentals
- Maintain a Long-Term View of the Markets
- Practice Risk-Aware Portfolio Construction

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