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ANNUAL INVESTMENT REVIEW AND OUTLOOK

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Summary and Major Conclusions:

The US equity market is positioned for positive returns over the next six to nine months on the basis of favorable business cycle trends. The odds of a major stock market rally are low, but returns of 10% are possible during the course of the year. The fixed-income market is vulnerable to a sustained rise in interest rates from a starting point of exceptionally low market yields. Global investors are likely to earn superior rates of return in select non-US equity markets.

- World equity markets performed well in the final quarter of last year, outperforming global bonds by a wide margin. Value stocks outperformed growth stocks for the first time in several years, while small-cap stocks outperformed large-cap stocks.

- For the full year, world financial markets performed exceptionally well, with double-digit returns in virtually all major asset classes, including domestic and international equities, domestic fixed income, and precious metals.

- The S&P 500 led all major asset classes in 2019 with a total return of 31.5%, propelled by a 50% return in the technology sector. International equities and US small-cap stocks lagged but each generated sizeable returns of 23.3% and 25.5%, respectively.

- The US investment-grade bond index also performed well during 2019, with a total return of 8.7%. All sectors of the bond market participated in the gains led by long-duration Treasury bonds (+15%) and high-grade corporate bonds (+14.5%).

- The overarching investment theme of 2019 was a relentless fear of recession, resulting in an ongoing attempt by investors to safeguard portfolios against losses. Virtually all measures of investor sentiment remained depressed throughout the year.

- The 2020 investment landscape should become increasingly favorable as the year unfolds. Economic, financial, and policy trends should support another year of positive returns, although annual returns are virtually assured of trailing those of 2019, and by a wide margin.

- The US economy should perform better this year, as strength in consumer spending and housing is augmented by a moderate recovery by the manufacturing and capital goods sectors. Corporate earnings per share (EPS) could increase by 5% to 10%.

- The world economy should experience a solid rebound, sparked by massive global monetary stimulus, an end to inventory liquidation in Germany, improving domestic demand in China, and resumed growth in world trade. Earnings growth outside the US could exceed that of the domestic economy.

- The expected economic and policy environment in 2020 should be more favorable for equity versus fixed-income markets. Rather than decelerating as in 2019, world economic and profit growth should accelerate throughout the year. Global monetary and liquidity conditions will likely remain highly expansionary.

- Common stocks almost always outperform bonds when economic growth is accelerating within a framework of stable inflation, accommodative monetary conditions, expansionary fiscal policy, and rising corporate earnings.

- Business profits are highly leveraged to industrial production, business capital investment, and trade, each of which was stagnant in 2019. A sustained recovery in these sectors will result in a disproportionately large increase in company earnings.

- An anticipated revival in world trade will be especially beneficial for earnings of foreign companies and US multinational firms. Depreciation of the US dollar will also support corporate earnings worldwide.

- Monetary conditions should remain highly accommodative throughout 2020. The Federal Reserve is determined to achieve faster growth and rising inflation, a bullish prescription for the equity market at the expense of the fixed-income market.

- Following ten years of underperformance, international equities should outperform those in the US, led by European and Asian stocks. Non-US equities should benefit from improving business conditions, more expansionary policy settings, and significantly more attractive valuations.

- Following a protracted period of underperformance, value stocks appear poised to generate superior returns relative to growth/momentum stocks. Receding market fears of recession should work to the advantage of value stocks.

- The outlook for bonds is poor. The next year should be a challenging period for bond investors, with most segments of the fixed-income market generating negative rates of return, led by US Treasuries.

- Corporate bonds offer little investment appeal at a current market yield of 2.8%, but should slightly outperform the Treasury market. Historically narrow credit spreads are vulnerable to a rise in default rates later this year and in 2021.

- Looking beyond a generally prosperous 2020, the US economy is likely to enter another slowdown phase during 2021, with rising odds of recession in 2022. The classic late-cycle pressures that typically emerge as business cycles mature could be evident later this year and in 2021.

- Long-term structural pressures could exacerbate the unfolding business cycle pressures beyond 2020, including a shift to anti-business government policies; the relentless growth in debt burdens worldwide; worsening demographic trends; and a long-term decline in globalization and free trade.

- There is a strong case to be made that 2020 could be a watershed year for investors. The compound annual return of 13.5% on US large-cap equities over the past decade is unlikely to be duplicated anytime soon; indeed, a period of payback in the form of below-average returns in future years appears more likely.

FINANCIAL MARKET REVIEW

World equity markets performed well in the final quarter of last year, outperforming global bonds by a wide margin. Financial market behavior during the fourth quarter was driven by a notable shift in market psychology, as investor obsession over recession gradually shifted toward increased economic optimism and reduced fear of recession. The shift in market sentiment was driven by several developments:

- Increased signs of strength in the US economy
- Preliminary signs of a manufacturing recovery in key foreign economies
- Signals from the Federal Reserve that monetary policy will be on hold
- Upbeat news regarding an imminent signing of a “phase one” trade deal between China and the US

In combination, these factors triggered a shift in investor sentiment from risk-off to risk-on, benefiting domestic and international stocks. For the final three months of the year, the S&P 500 generated a total return of 9.1%. International stocks also performed well with a total return of 7.9%, while US small-cap stocks performed best with a gain of 10%. All segments of the fixed-income market were essentially flat in the quarter, with outright losses on long-duration Treasury bonds.

FULL YEAR RETURNS

For the full year, world financial markets performed exceptionally well, with double-digit returns in virtually all major asset classes, including domestic and international equities, domestic fixed income, and precious metals. The NASDAQ and S&P 500 stock indexes led all markets with total returns of 36.7% and 31.4%, respectively, the largest annual gains since 2013. US small-cap stocks lagged the large-cap indexes but generated a respectable return of 25.5%. International equities also performed well but also lagged the US market with a total return of 23.3%.

Fixed Income: Bonds also performed well in 2019, sparked by a sharp decline in long-term interest rates. The total return on domestic high-grade bonds was 8.7%, as measured by the Barclays Capital US Aggregate Bond Index. All sectors of the bond market participated in the gains, led by long-duration Treasury bonds (+15.1%), investment-grade corporate bonds (+14.5%), high-yield corporate bonds (+14.3%), and emerging market bonds, which gained 14.4%. Crude oil and gold prices rose by 35% and 18%, respectively. Over the past decade, the 13.5% compound annual return on the S&P 500 easily outpaced the 3.8% annualized return of the Barclay’s bond index (see chart 1).

Chart 1: Plunge in US Treasury Bond Yields
Ten-Year US Treasury Bond
Market Yield to Maturity
Source: Federal Reserve

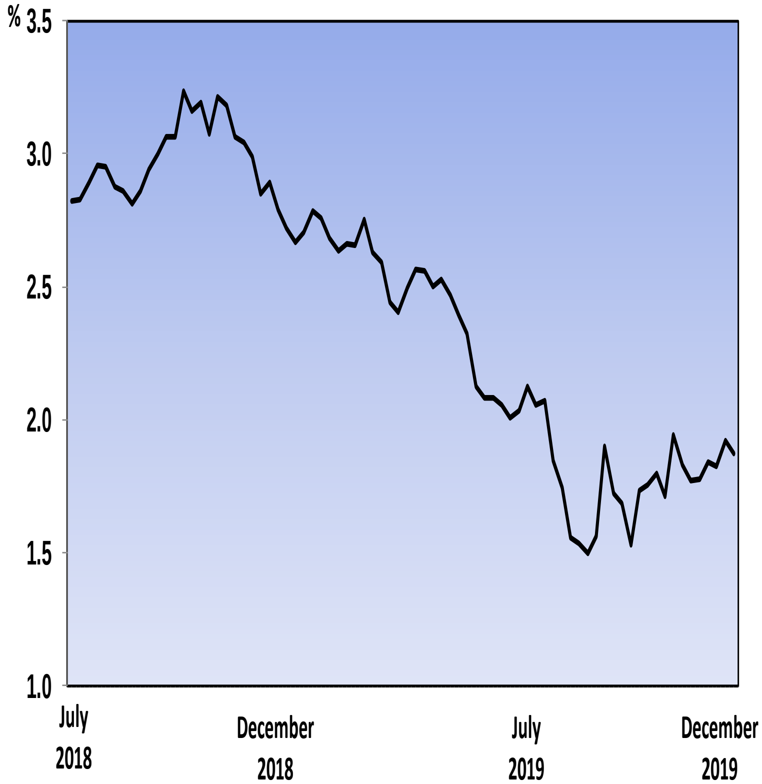
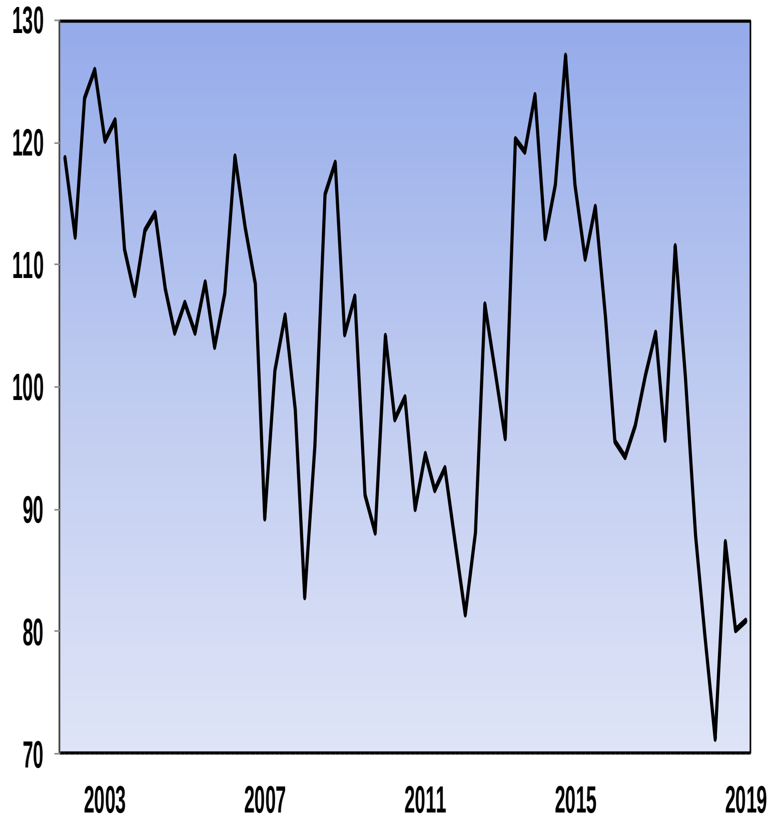


Chart 2: Investor Confidence Remains at a Depressed Level
Monthly Survey of Institutional Investors
Source: State Street Global Markets



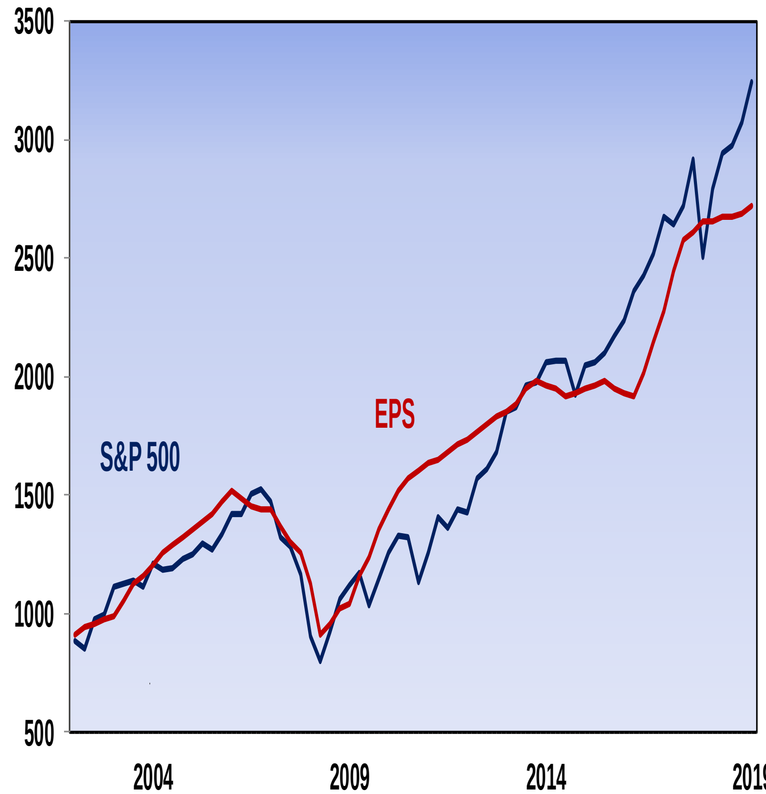
Fear and Risk Aversion: *The overarching investment theme of 2019 was a relentless fear of recession, resulting in an ongoing attempt by investors to safeguard their portfolios against market losses*. The result was a record exodus out of risk assets and a stampede into safe-haven assets, such as high-quality government bonds and low-risk defensive stock groups. Virtually all measures of investor sentiment were depressed for the majority of the year (see chart 2).

Paradox of Returns: The spectacular returns from world equity markets in 2019 appear inconsistent with prevailing investor caution and risk aversion. Ultra-safe government bonds performed well but riskier equity markets performed even better. This combination of circumstances is a ***paradox***. There are four factors that explain why equities outperformed bonds in a distinct risk-off environment of heightened fear and risk aversion.

- **Calendar Effect**: Equity returns in 2019 were distorted by a calendar effect — most of the exceptional gains in world equity markets resulted from a rebound from the extremely depressed base at yearend 2018. From the end of the calendar year, the US equity market return was **31.5%**; *measured from the market peak only several months earlier (October 2018), the US equity market generated a total return of only **10%*** (see chart 3).

Chart 3: 2019 Equity Market Returns Flattered by Low Starting Point
S&P 500 Stock Index
Source: Bloomberg

Chart 4: US Stocks Ran Ahead of Corporate Earnings in 2019
S&P 500 Stock Index
Earnings per Share (EPS), S&P 500 Companies
Source: Standard & Poor's, FactSet



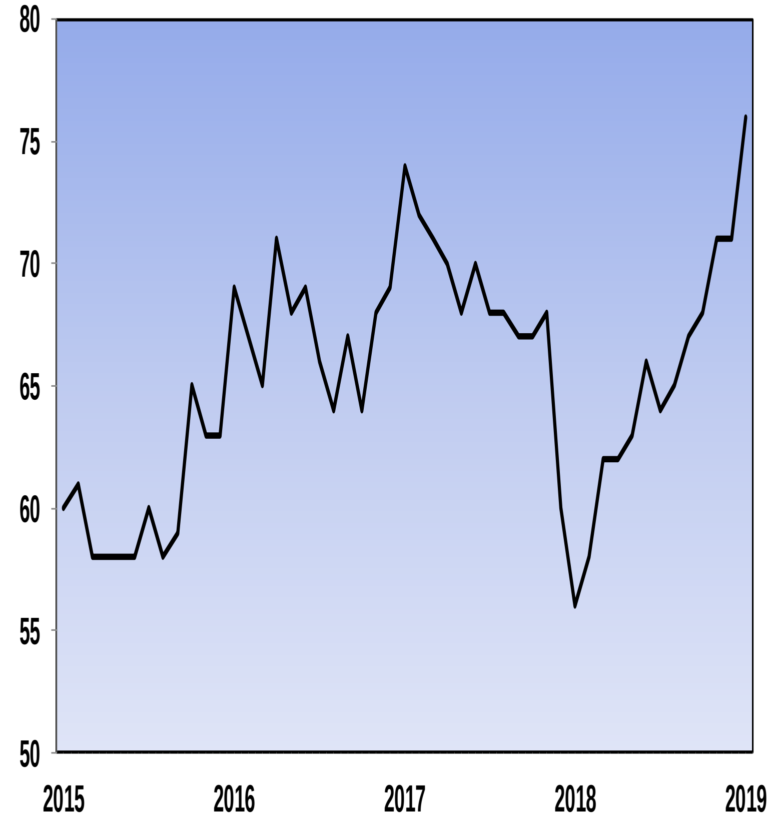
- **Monetary Policy and Valuation**: Virtually all of the gains in the equity market resulted from increased valuation — a steady expansion in the market price-to-earnings (P/E) ratio. The market return from earnings growth was virtually zero. According to classic finance theory, equity valuations are a function of interest rates, inflation, and the thrust of monetary policy. *These three factors pushed P/E ratios higher during 2019, more than offsetting broad-based weakness in earnings* (see chart 4).

- **Equity Sectors**: The equity market was highly bifurcated in 2019, with relative strength in *safe-haven defensive sectors* and weakness in economically sensitive sectors. The equity market was also driven by *bond substitutes* such as utilities, communications services, real estate, and consumer staples, all of which were viewed as safe-haven pockets of the equity market.

- **Technology Stocks**: A final explanation pertains to the voracious investor appetite for technology stocks. Technology stocks are highly coveted because of their strong earnings momentum and rapid secular growth rates in an environment of profound uncertainty regarding economic growth. The return on the S&P 500 technology sector last year was **50.3%** (see chart 5).

Chart 5: Technology Stocks Led Market Higher in 2019
S&P 500 Technology Sector Index
Source: Bloomberg

Chart 6: Homebuilder Confidence at a Multi-Decade High
Monthly Survey of Homebuilder Business Activity
Source: National Association of Home Builders



FINANCIAL MARKET LANDSCAPE

The 2020 investment landscape is likely to be more favorable relative to last year, resulting in positive rates of return for most of this year. Economic, financial, and policy trends should support another year of rising asset prices, although year-over-year market gains are virtually certain to trail those of 2019, perhaps by a wide margin. The macro environment for 2020 can be best summarized as follows:

- The US economy should perform better than it did in 2019, as strength in consumer spending and housing is reinforced by a recovery in the manufacturing and capital goods sectors (see chart 6).

- The world economy should experience a solid rebound, sparked by massive global monetary stimulus, an end to inventory liquidation in Germany, improving domestic demand in China, and resumed growth in world trade.

- Inflation should remain stable throughout the year. Currently at an annual rate of 1.6%, core consumer inflation could drift moderately higher, but should not exceed the Federal Reserve's long-term target of 2% (see chart 7).

Chart 7: Consumer Inflation Under Excellent Control
Core Consumer Price Deflator
Excluding Food and Energy, Annual % Rate
Source: Bureau of Economic Analysis

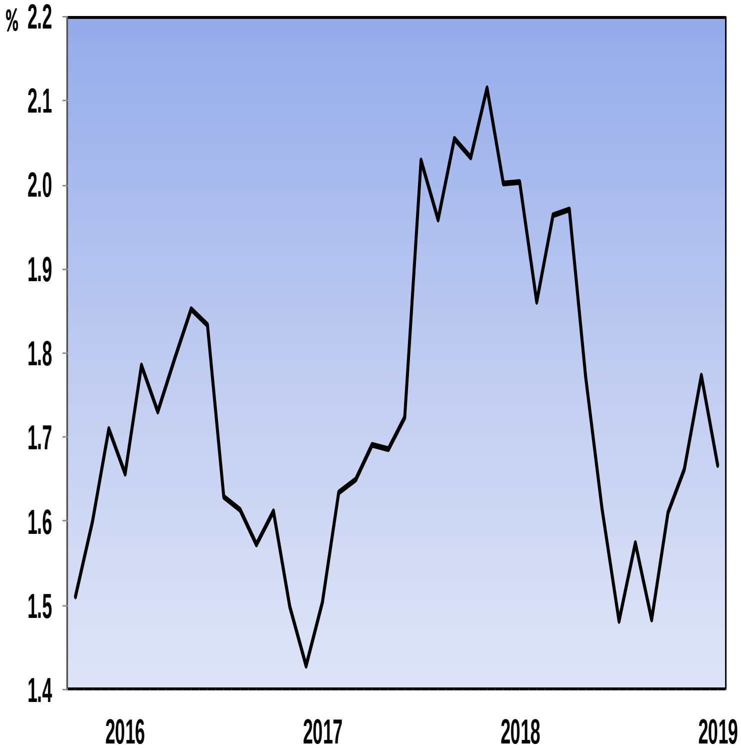
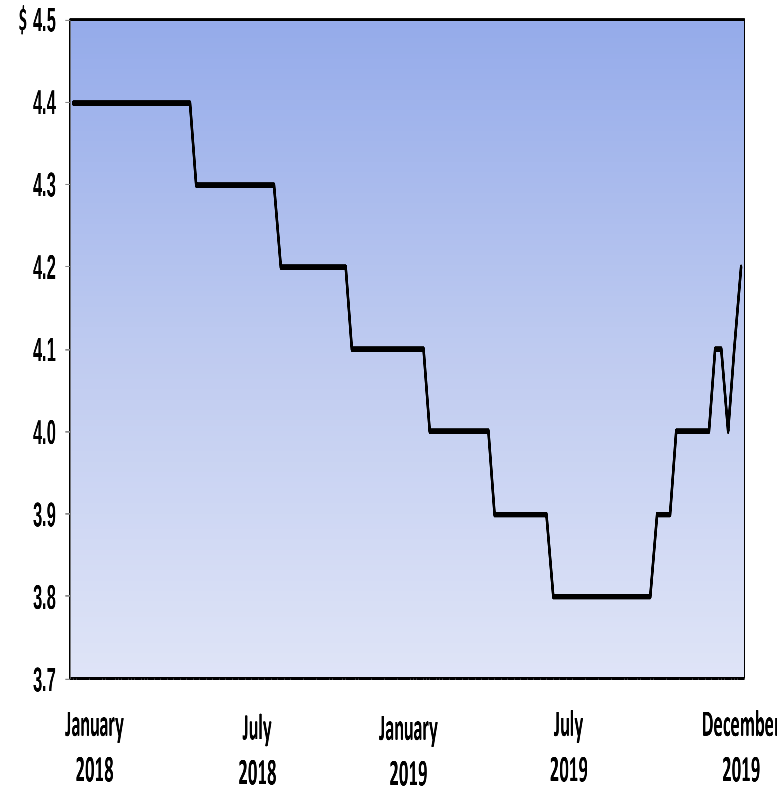


Chart 8: Rapid Growth in Federal Reserve Balance Sheet
Assets Held by the Federal Reserve ($ Trillions)
Source: Federal Reserve



- Corporate earnings were flat in 2019 but should gradually accelerate as the year unfolds. My forecast for 2020 assumes earnings growth for the companies in the S&P 500 within a range of 5% to 10%.

- Monetary conditions should remain highly accommodative throughout 2020, with the Fed unlikely to raise its policy rate until 2021. The Fed's strategic goal is to promote faster GDP growth and rising inflation, a bullish prescription for the equity market at the expense of fixed income. Following 12 months of shrinkage, the Fed's *balance sheet* is expanding again, enhancing liquidity conditions (see chart 8).

- Financial conditions remain extremely healthy. Credit is in abundant supply and available to virtually all borrowers. In addition, credit quality is extremely healthy for the 11th year of a business expansion, with delinquencies, defaults, and credit losses at depressed levels.

- Valuation is a headwind for both stocks and bonds, but especially the latter. The exceptionally low level of starting-point market yields is a major disadvantage for prospective returns on bonds. At a P/E ratio of 18x, the equity market is also expensive. Future returns on domestic equities are unlikely to exceed the growth rate in earnings per share (EPS).

2020 INVESTMENT OUTLOOK

In terms of global asset allocation, investors should overweight stocks over bonds and international stocks over US equities. The domestic equity market should easily outperform the fixed-income market in 2020, although economic and policy conditions for stock investing could deteriorate later in the year and throughout of 2021. Investors should not expect another year of exceptional gains as in 2019, but instead rates of return that approximate long-term historical averages. Global bonds should perform poorly this year. Major investment themes for 2020 can be summarized as follows:

- The expected economic and policy environment in 2020 favors equity versus fixed-income markets. Rather than decelerating as occurred in 2018 and 2019, world economic and profit growth should accelerate throughout the year. Global monetary and liquidity conditions should remain highly expansionary.

- Common stocks almost always outperform bonds when economic growth is accelerating within a framework of stable inflation, accommodative monetary conditions, expansionary fiscal policy, and rising corporate earnings.

- Business profits are highly leveraged to industrial production, capital investment, and trade, each of which was stagnant in 2019. A sustained recovery in these three sectors will result in a disproportionately large increase in company earnings relative to the growth rate in GDP.

- Following ten years of underperformance, international equities should outperform those in the US, led by Europe and Asia. Non-US equities should benefit from improving business conditions, more supportive policy settings, and more attractive valuations.

- Also following a protracted period of underperformance, value stocks appear poised to generate superior returns relative to growth/momentum stocks. Market fears of recession are the critical determinant of relative returns between value and growth. Receding fears of recession should work to the advantage of value stocks.

- The outlook for bonds is poor. The next year should be a challenging period for bond investors, with most segments of the fixed-income market generating negative rates of return.

- Government bond yields should move modestly higher during the year, anchored by a steady federal funds rate of 1.75%, implying only a gradual steepening of the yield curve. A more rapid rise in bond yields awaits a rise in inflation and a strategic shift in monetary policy, which are not likely to occur until 2021.

Chart 9: Sharp Slowdown in World Trade
Index of World Trade Volume
Source: International Monetary Fund

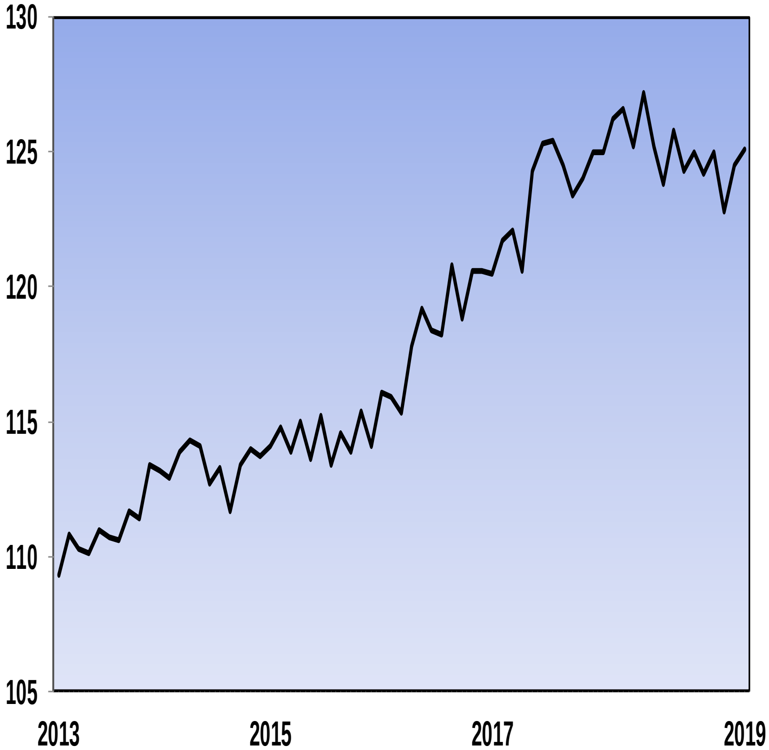
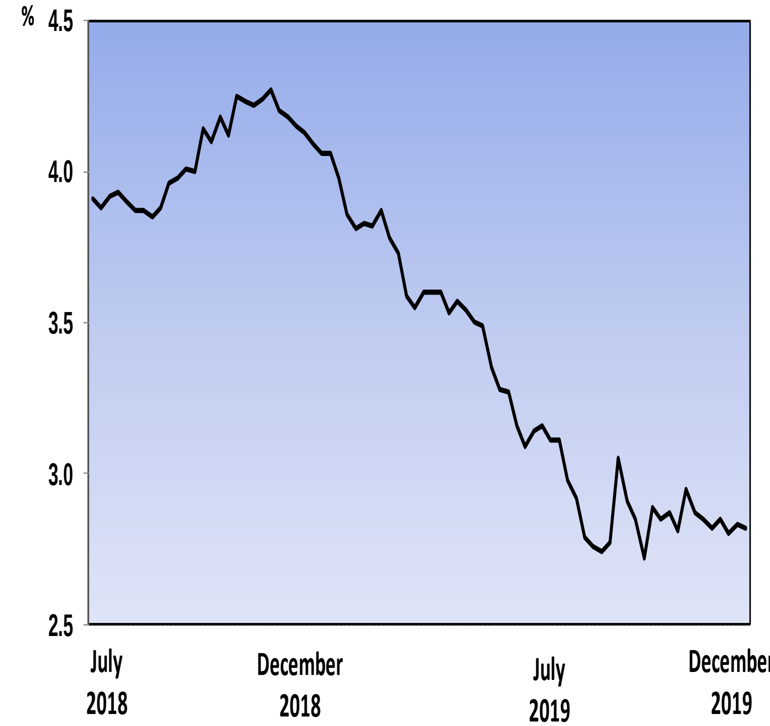


Chart 10: Corporate Bond Yields Near All-Time Lows
Market Yield to Maturity
Investment-Grade Corporate Bond Index
Source: Bloomberg



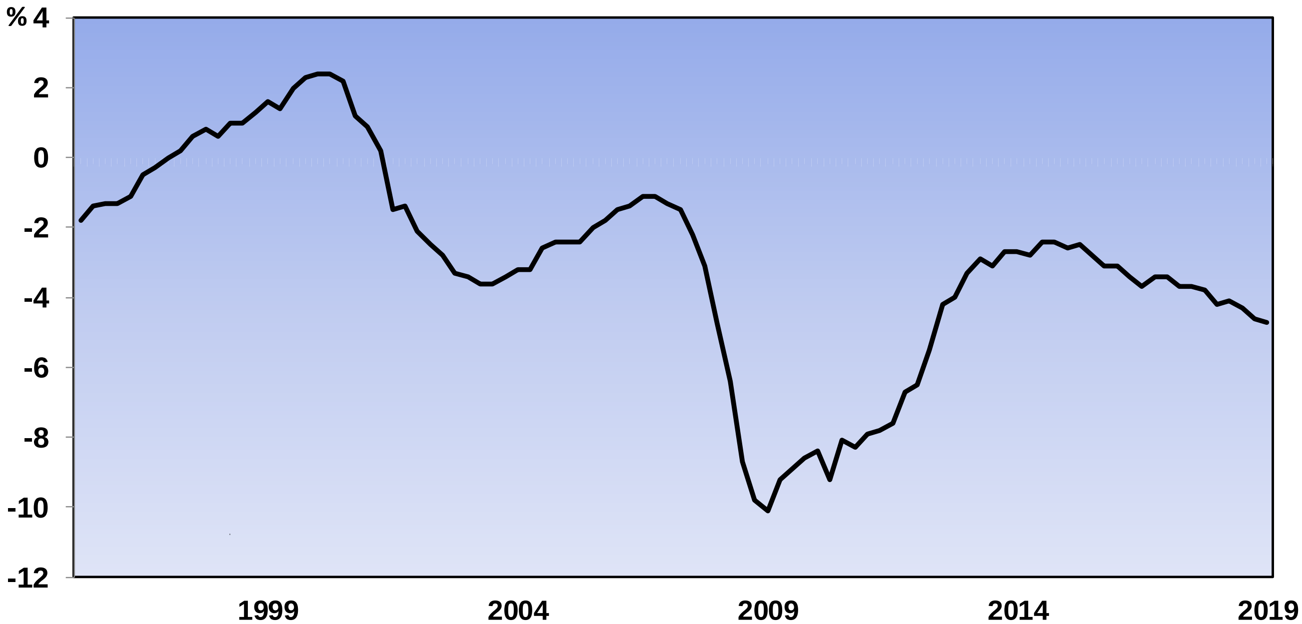
- An anticipated revival in world trade will be especially beneficial for earnings of foreign companies and US multinational firms. Depreciation of the US dollar will also support corporate earnings worldwide (see chart 9).

- Corporate bonds also offer little investment appeal at a current market yield of 2.8%, although returns should exceed those in the Treasury market. Historically narrow credit spreads are vulnerable to a rising default rate later this year and in 2021 (see chart 10).

Investment Summary: The US equity market is positioned for positive returns over the next six to nine months on the basis of favorable business cycle trends. The odds of a ***major*** stock market rally are low, but a 10% return is possible during the course of the year. *Value stocks are likely to outperform growth/momentum stocks for the first time in many years*.

The fixed-income market is vulnerable to a sustained rise in interest rates from a starting point of exceptionally low market yields. Global investors are likely to earn superior rates of return in *select non-US markets* in the context of accelerating world GDP growth, a revival in world trade, a declining US dollar, and far more attractive valuations.

Chart 11: Negative Outlook for US Budget Deficit
US Budget Deficit Percentage Share of US GDP
Source: US Treasury



A PRELIMINARY LOOK BEYOND 2020

Following a period of acceleration over the next year, US GDP growth is likely to enter another slowdown phase during 2021, possibly culminating in an outright recession in 2022 or 2023. Company earnings will respond to the trend in GDP, which implies a period of increased strength throughout 2020, followed by renewed weakness in 2021 and 2022, as company revenues and profit margins come under pressure.

Late-Business Cycle Risks: Along with slowing GDP and profit growth, the US equity market faces additional headwinds beginning in 2021: Rising borrowing costs; rising inflation; labor market pressures; a rising federal budget deficit; and emerging credit quality issues. In short, the classic late-cycle economic and financial pressures that typically surface as a business cycle matures could become evident later this year and in 2021, with obvious negative implications for financial markets (see chart 11).

The 2020 Elections: The 2020 elections represent a major wild card in the economic and investment outlook. The thrust of economic policy in future years will be heavily dependent upon the presidential election outcome. A Trump victory would likely imply continued expansionary fiscal policies, including additional tax cuts and spending, resulting in rising budget deficits. It would also imply ongoing risk of tariff weaponization and continued stringent immigration policies.

- **Democratic Party Policies**: A Democratic victory would likely imply higher tax rates on businesses and upper-income families; reinstatement of regulations that were eased under Trump; a more stringent anti-trust policy; a more open immigration policy; and major reforms within the healthcare system. Trade tensions with China would likely continue, but with a reduced emphasis on tariffs as a negotiating tool.

A WATERSHED YEAR

Within a longer-term context, there is a strong case to be made that 2020 could be a watershed year for investors. *The compound annual return of 13.5% on US large-cap equities over the past decade is unlikely to be duplicated anytime soon; indeed, a period of payback in the form of below-average returns appears likely*. Beyond the traditional business cycle, there are also *powerful structural forces* at work, suggesting that the economic and investment outlook beyond 2020 could become more treacherous:

- An aging business expansion cycle that will exhibit increasing recessionary tendencies in coming years

- The potential for a major reversal in government economic policy — from a recently strong pro-business bias toward populist, socialist, and anti-capitalist tendencies

- Growing debt burdens worldwide, exerting downward pressure on growth, most notably in China and other developing economies, but also in the US

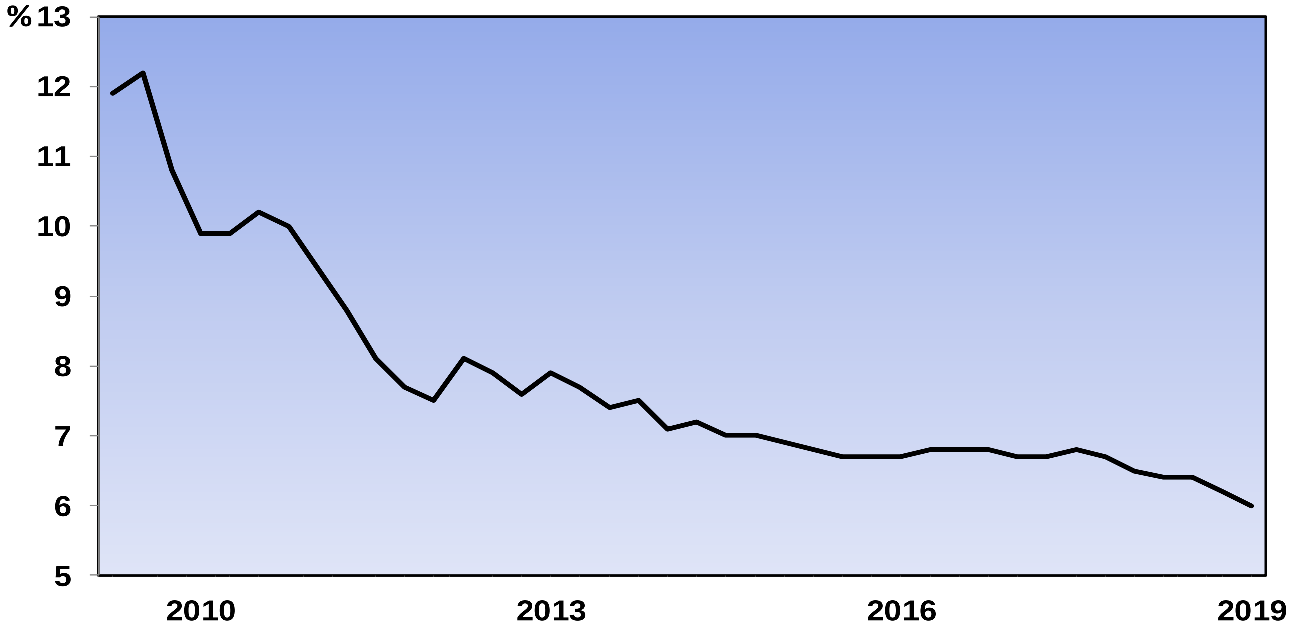
- Increasingly negative demographic factors pertaining to slowing population growth, an aging population, and a steadily increasing dependency ratio will also dampen growth prospects

- A cresting in China's multi-decade industrialization process, which means that the boost to the global economy and world trade emanating from China since 2000 will steadily decline in coming years (see chart 12)

- A further shift away from globalization with the spread of protectionism and economic isolationism, depriving the world economy of the powerful growth engine of the past several decades

- Finally, traditional measures of valuation indicate that most asset classes are richly valued, thereby reducing the potential for ***prospective*** returns from current elevated starting points

Chart 12: Slowest Economic Growth in China in Nearly Three Decades
China GDP Growth, Adjusted for Inflation, Annual Rate
Source: China National Bureau of Statistics



It is somewhat premature for investors to develop a high level of conviction regarding the potential theme of a ***2020 inflection point***, mainly because these *epic and titanic structural forces* are extremely difficult to forecast. It is also premature because of the *favorable short-term business cycle forces that are expected to dominate the economic and investment landscape during most of 2020*. However, financial markets could discount these potentially worrisome trends later this year and in 2021, making the case for a more defensive asset allocation strategy beyond 2020.

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Bloomberg Barclays U.S. Treasury Inflation-Protected Securities (TIPS) Index: Measures the performance of rules based, market value-weighted inflation protected securities issued by the U.S. Treasury. It is a subset of the Global Inflation-Linked Index (Series-L).

CBOE Volatility Index: An index of implied equity market volatility, reflecting the market estimate of future volatility for the S&P 500 Stock Index over the next 30 days, using options.

MSCI Emerging Market Index: An index of equity market performance for developing markets, primarily in Asia, Latin America, and Eastern Europe. The index tracks both large-cap and small-cap stocks and is weighted by market capitalization.

MSCI World Ex US Index: Measures the performance of the large and mid-cap segments of world, excluding US equity securities. It is free float-adjusted market-capitalization weighted.

Russell 2000 Small-Cap Index: Is an index measuring the performance of approximately 2,000 small-cap companies within the United States.

S&P 500® Index: Measures the performance of 500 widely held stocks in US equity market. Standard and Poor's chooses member companies for the index based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility, and transportation companies. Since mid-1989, this composition has been more flexible and the number of issues in each sector has varied. It is market capitalization-weighted.

State Street Investor Confidence Index: measures investor confidence or risk appetite quantitively by compiling actual buying and selling patterns of institutional investors.

US Trade-Weighted Dollar Index: An index that measures the value of the US dollar in relationship with other currencies, statistically weighted on the basis of importance to the US as trading partners.

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