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2019 REVIEW AND OUTLOOK FOR 2020

2019 began with anxiety over the direction of stock prices due to the stock market plunge that occurred during the fourth quarter of 2018. That decline was caused primarily due to concerns that the U.S. economy could fall into recession as the Federal Reserve Board was raising interest rates while the U.S. trade war with China was escalating. However, the Fed changed course in early 2019 and decided to not only discontinue raising interest rates but to begin a campaign of lowering interest rates three times during the year in an attempt to support the U.S. economy. Simultaneously, President Trump and his economic advisors continued to reassure investors that the trade war with China would eventually be resolved. Ultimately the first phase of an agreement was announced in December.

Although 18 months of trade war with China exacerbated a global economic slowdown and negatively impacted U.S. manufacturing in 2019, U.S. consumer spending held up relatively well due to a strong job market, rising wages, low oil prices, and low borrowing rates. Despite political, geopolitical, and economic uncertainties, the U.S. stock market recovered dramatically in 2019 from its 2018 decline, as the S&P 500 Index ended 2019 up 28.88%, while the Dow Jones Industrial Average ended the year up 22.34%. The Bloomberg Barclays U.S. Intermediate Government/Credit Bond Index increased by 6.80% during 2019.

While the major U.S. stock market indices performed well during a politically and economically tumultuous year, there are some concerns regarding the reasons for last year's positive market performance to keep in mind for this year. For example, one of the main explanations for why the stock market appreciated is that the Fed made it clear that they would lower interest rates and keep them low for quite some time. Interest rates in the bond market also declined last year as foreign investors bought U.S. Treasury bonds in large quantities because bond interest rates in the U.S. were higher than in most other developed countries. As bond prices rose due to significant Treasury bond purchases, bond yields declined (there is an inverse relationship between bond prices and bond yields). This very low interest rate environment led investors to allocate more money to stocks hoping to generate better returns than lower-yielding fixed income investments. However, interest rates are once again at historically low levels, and the Fed may no longer remain as accommodative in the future. Foreign investors could also stop buying U.S. Treasuries in such large quantities or even begin selling their U.S. bond holdings. If this leads to rising interest rates, it can potentially cause last year's stock market gains to stall or reverse.

Another reason for unease over last year's stock market performance is that it appears that stocks have generally become overvalued considering the relatively slow growth of corporate earnings and the U.S. and global economies in general. If stocks continue to appreciate disproportionately to corporate earnings and economic growth, a correction in price and/or time is likely to occur at some point, bringing stock prices back in line with corporate earnings prospects. Additionally, corporations have been buying back their own stock, boosting their share prices over the past several years at a rapid pace. If this pace of corporate stock buying subsides, stock price appreciation may dissipate. Also, last year investors correctly anticipated that "Phase One" of a trade deal with China would be agreed to. However, if that portion of a larger anticipated trade deal with China is violated or additional progress in the trade war with China does not materialize this year, investors may once again become worried about its negative impact on corporate earnings and the global economy.

Moving forward, although election years are typically positive for stocks, this year may be different as impeachment hearings and the likelihood of a contentious election could give rise to additional stock market volatility. Although it is unlikely that President Trump will be removed from office, impeachment proceedings will likely continue to cause stagnation in Congress, leading to a lack of progress on other economic issues. Also, while elections do not typically result in changes in long-term market trends, they can create short-term market instability. Finally, uncertainty regarding the outcome of Brexit could create further worries for investors.

Despite these concerns, as long as the U.S. economy avoids a recession, it is unlikely that a major bear market decline is imminent. The worst stock market declines tend to occur during U.S. recessions and, right now, a recession does not appear to be an immediate threat. In fact, it would be very rare for there to be a recession in the United States while both interest rates and oil prices are very low. Therefore, any market declines this year may create opportunities for investors to allocate additional funds to parts of the stock market that did not perform as well last year, such as foreign stocks and small company stocks. In the meantime, we continue to remain overweight in domestic large company stocks. We also prefer short-term bonds rather than long-term bonds because long-term bonds offer little additional interest and more risk than short-term bonds. We also continue to believe that gold is a reliable hedge against potential future inflation and continued political and economic uncertainty.

As always, please contact us if you have any questions regarding your investments or the financial markets in general.

* *Index returns were obtained from the Wall St. Journal and Bloomberg Barclays on January 2, 2020.*