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Litman Gregory Year-End 2019 Investment Commentary

Looking Back: 2019 Market Review

What a difference a year makes. Our 2018 year-end investment commentary was subtitled, "An Extremely Difficult Year to Make Money in the Financial Markets." Just about every major asset class lost money in 2018. In 2019, that was turned on its head. Pretty much *everything went up*. *A lot*.

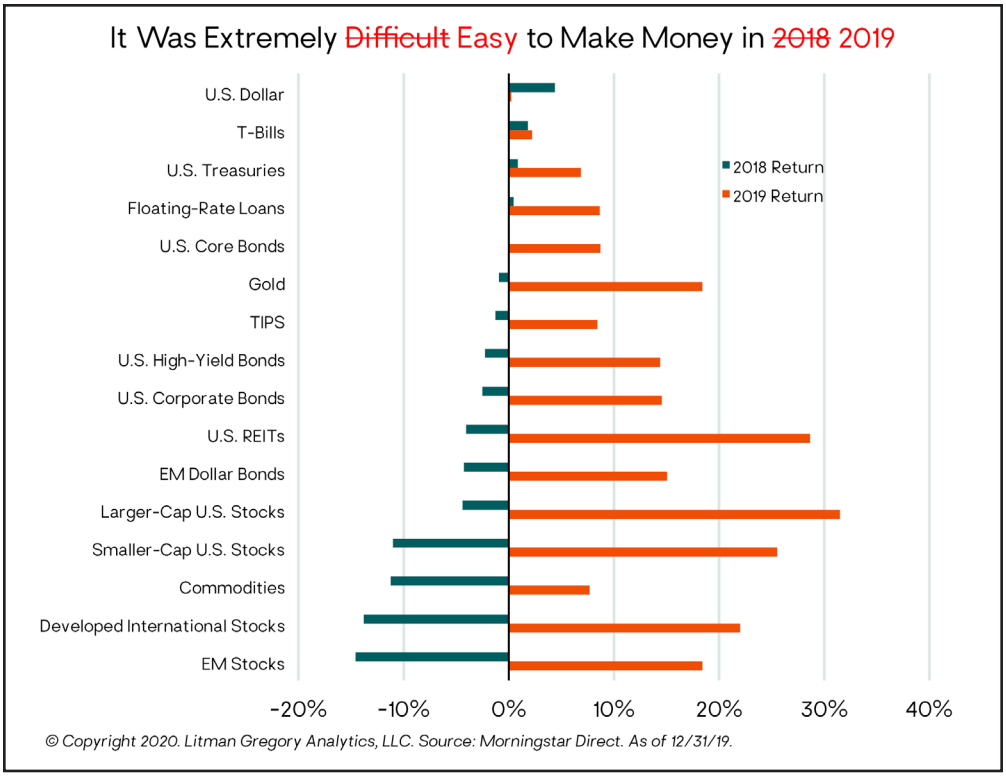
We've reproduced our year-end 2018 chart on the next page, updated with the 2019 returns.

December Benchmark Returns			
	MTD	QTD	YTD
EQUITY BENCHMARKS			
Vanguard 500 Index	3.0%	9.0%	31.3%
iShares Russell 1000 ETF	2.8%	8.9%	31.1%
iShares Russell 1000 Value ETF	2.7%	7.3%	26.1%
iShares Russell 1000 Growth ETF	2.9%	10.5%	35.9%
iShares Russell 2000 ETF	2.8%	9.9%	25.4%
Vanguard REIT	0.8%	0.6%	28.8%
iShares MSCI ACWI ETF	3.4%	8.7%	26.6%
Vanguard FTSE Developed Markets ETF	3.6%	8.3%	22.6%
Vanguard FTSE Europe ETF	4.5%	9.9%	24.9%
Vanguard FTSE Emerging Markets ETF	7.1%	11.9%	20.8%
FIXED-INCOME BENCHMARKS			
Vanguard Total Bond Market Index	-0.1%	0.0%	8.6%
Vanguard Intermediate-Term Tax-Exempt	0.3%	0.6%	6.8%
iShares TIPS Bond ETF	0.3%	0.6%	8.3%
ICE BofA Merrill Lynch U.S. High Yield Cash Pay Index	2.1%	2.6%	14.4%
S&P/LSTA Leveraged Loan Index	1.6%	1.7%	8.6%
ALTERNATIVE BENCHMARKS			
HFRX Global Hedge Fund Index	1.3%	2.6%	8.7%
Bloomberg Commodity Index	5.0%	4.4%	7.7%
SG Trend Index	-0.5%	-3.8%	9.3%
3-Month LIBOR	0.2%	0.5%	2.6%

Across global equity markets, larger-cap U.S. stocks were once again at the top of the leader board. The S&P 500 index posted gains in every quarter and surged 9% in the fourth quarter to end the year at an all-time high. Its 31% total return was its second-best year since 1997. (It was up 32% in 2013.) Smaller-cap U.S. stocks rose 25.4% for the year (iShares Russell 2000 ETF). Foreign equity markets were also strong. European stocks gained 9.9% in the fourth quarter and 24.9% for the year (Vanguard FTSE Europe ETF). After struggling in the third quarter, emerging-market (EM) stocks shot up almost 12% in the fourth quarter and returned 20.8% for the year (Vanguard FTSE Emerging Markets ETF).

Credit markets were also strong in 2019. High-yield bonds gained 14.4% and the floating-rate loan index rose more than 8.6% (the ICE BofA Merrill Lynch U.S. High-Yield Cash Pay Index and the S&P/LSTA Leveraged Loan Index, respectively.

Given what would appear to be a "risk-on" investment environment, it may seem surprising to see investment-grade core bonds also post very strong returns. The core bond index was flat in the fourth quarter but gained 8.6% for the year—its best annual return since 2002 (Vanguard Total Bond Market Index). However, in 2002, when core bonds returned 10.3%, the S&P 500 plummeted 22% in its final down-leg of a three-year bear market.



Why did both stocks (risky assets) and bonds (defensive assets) appreciate sharply in 2019? The key driver was the Federal Reserve's sharp U-turn to accommodative monetary policy. This was followed by other central banks across the globe.

Coming into 2019, the Fed was indicating it expected to *raise* the federal funds policy rate three more times (75 basis points), on the heels of four rate hikes in 2018. This led investors to fear that excessively tight monetary policy could tip the U.S. and global economies into recession, bringing an equity bear market with it. The ongoing U.S.-China trade conflict didn't help matters.

Ultimately, the Fed ended up *cutting* rates three times in the second half of 2019. Late in the year, it also started expanding its balance sheet again via purchases of Treasury Bills in order to boost banking system reserves and inject liquidity into the short-term lending markets. Other major central banks also cut rates and/or provided additional stimulus to the markets via quantitative easing during the year. This lessened recession fears.

Meanwhile, inflation (and inflation expectations) remained at or below central bank targets, mitigating any concern that monetary policy would be tightened again any time soon. The bond market rallied, with the 10-year Treasury yield dropping from 2.70% at the beginning of the year to as low as 1.45% in September, ending the year at 1.92%.

The U.S. equity market responded to the Fed policy reversal and stimulus much as it has during the past 10 years—by bidding up stock prices and valuations. A détente in the U.S.-China trade war late in the year (the "phase one" deal) was an added boost to market sentiment.

Note that it wasn't corporate profit growth that drove U.S. stocks higher in 2019. Reported earnings for the S&P 500 were flat over the first three quarters, and a mid-single-digit percentage increase is projected for the fourth quarter. The lion's share (roughly two-thirds) of the S&P's 31% return came from a sharp expansion in valuations: The S&P 500's P/E ratio shot up from roughly 19x to 23x at year-end (based on the trailing four quarters of earnings).

Looking Back: Key Drivers of Our 2019 Portfolio Performance

It's fair to say that most investors were surprised by the financial markets in 2019. At the end of 2018, as far as we can tell, not a single Wall Street strategist predicted the 10-year Treasury yield would drop below 2% or that stocks would soar 20% to 30% or more, let alone that *both* would happen simultaneously.

We don't make—and our investment process isn't based on—12-month market predictions. Instead, we incorpo-

rate a *range of potential outcomes*, typically looking out over a *medium- to longer-term* time frame (five to 10-plus years). We then use a short-term (12-month) time frame to stress-test our portfolios against potentially severe downside scenarios and to ensure their risk exposures are consistent with each portfolio's investment objective.

Our portfolios reaped the benefits of our multiscenario, long-term, diversified investment approach in 2019. We also experienced some of the inherent tradeoffs that come with it in any given year or shorter-term period.

Tailwinds …

First and foremost, the benefits. Simply put, our portfolios generated strong returns for the year. We meaningfully participated in the surprising global equity market rally. While our balanced portfolios maintained a somewhat defensive tilt, our overall exposure to equities was (and is) still significant.

Similarly, we've maintained meaningful strategic exposure to core bonds in our more conservative portfolios as ballast in the event of a recession or an unexpected external shock, such as a geopolitical event that leads to a flight-to-safety.

So, the very strong stock and bond market rallies were a tailwind for our globally diversified portfolio returns in 2019.

… and Tradeoffs

Now for the tradeoffs. In 2019, most of our *tactical* portfolio positions were headwinds to performance.

As a reminder, our tactical positions are asset classes or investment strategies that look compelling on an "expected return versus risk" basis *compared to U.S. stocks and core bonds*, analyzed across the *range of scenarios* we think are reasonably likely to play out over *the medium term* (a market cycle). If/when we identify such opportunities, we tactically *tilt* our portfolios to them. Potential opportunities have a high hurdle to qualify as a tactical allocation (a "fat pitch"). And the extent of our tactical exposure depends on our assessment of the probability and magnitude of the tactical opportunity. Finally, even when we have tactical positions, we maintain *strategic* (long-term) exposure to U.S. stocks and core bonds for diversification purposes—implicit acknowledgement of the inherent uncertainty about the path of future investment outcomes.

Our current tactical positions are as follows: (1) a modest overweight to European and EM stocks; (2) allocations to lower-risk and/or diversifying alternative strategies (such as arbitrage funds and trend-following managed futures funds); and (3) allocations to flexible, actively managed, fixed-income funds and floating-rate loan funds. (We discuss these positions later in this commentary.)

These tactical positions all made money in 2019. But in aggregate they didn't gain as much as the mix of U.S. stocks and core bonds from which they were funded.

In a nutshell, 2019 was a year in which the benefits of global equity diversification and a longer-term, valuation-driven, tactical allocation approach were not apparent.

Overvalued U.S. stocks became *even more* expensive while outperforming other global markets (continuing a multiyear trend). And within the U.S. market, growth stocks again trounced value stocks, extending a multiyear winning streak. This has been a headwind to many of our active U.S. equity managers compared to the S&P 500.

In addition, the diversification and risk management benefits of alternative strategies within a traditional balanced portfolio were mostly irrelevant given the very strong performance of core bonds *and* U.S. stocks. (A traditional 60%/40% U.S. stock/bond portfolio had its highest total return since 1997, and its fourth-highest *risk-adjusted* return over the past 40 years.)

Finally, our active bond fund managers, broadly speaking, believed it prudent to not take on much interest rate

risk or credit risk in their funds in 2019. As a result, most of them trailed the red-hot core bond index, after having meaningfully outperformed it over the prior several years.

At year-end, based on our analysis, we continue to believe these tactical positions improve our portfolios' risk-return profile and will add value relative to U.S. stocks and bonds looking ahead over the next several years as this extended market/economic cycle plays out.

Looking Ahead: 2020 … and Beyond

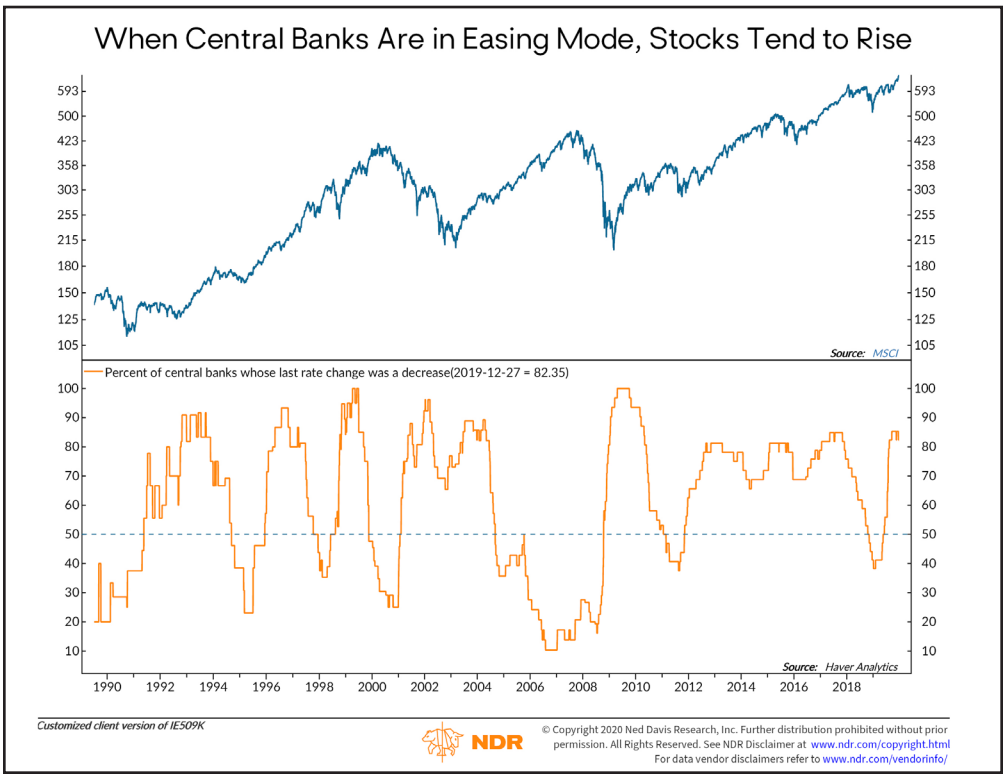
As investors (and humans), we think it is helpful to maintain a balanced mindset—to be financially and emotionally prepared for whatever the markets may throw our way in the coming year. (Related to this, it's critical to be invested in a portfolio whose investment policy and risk profile are aligned with your personal financial objectives and attitudes toward risk.)

In our year-end 2018 investment commentary, we described two very different potential scenarios for the global economy and financial markets in 2019. One was bullish for stocks and bearish for bonds, and the other forecasted stock market losses and bond market gains. We said we thought either type of scenario had a reasonable chance of playing out (as well as other variations) and that our portfolios were positioned and prepared for either one, with a mix of offensive, defensive, and diversifying investments. As it turned out, both stocks and bonds rallied, and by much more than *either* scenario predicted.

As we look ahead to the financial markets in 2020, there are again reasons for shorter-term optimism—*cautious* optimism—for stocks. There are also notable risks that could lead to a volatile and challenging year. We list several of the pros and cons below. Suffice it to say, economic and geopolitical uncertainty remain elevated and the range of market outcomes wide.

Some Reasons for Market Optimism in 2020

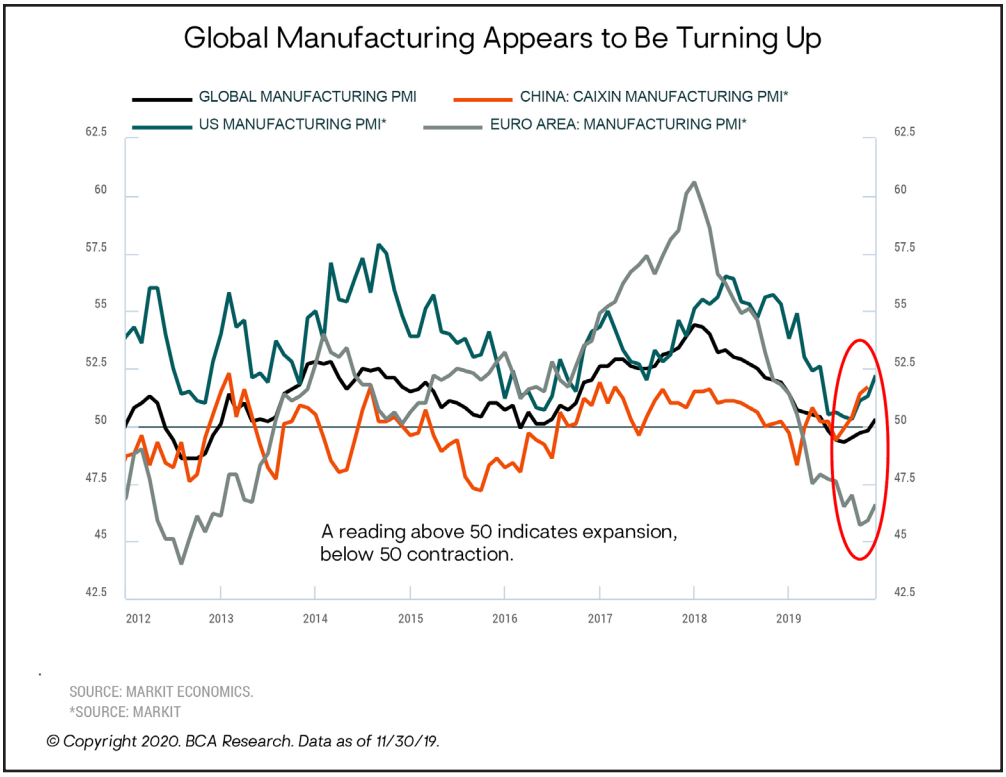
1) Accommodative central bank monetary policy and easier financial conditions should support at least a modest rebound in global economic growth. Assuming interest rates don't sharply rise (see bullet point four), this economic backdrop should be positive for equity markets and other risk assets (e.g., credit markets).



2) The vast majority of global central banks are now in easing mode. Historically, this is associated with global eq-

uity gains and an economic/ manufacturing recovery.

3) The Global Manufacturing Purchasing Managers' Index (PMI), an economic leading indicator, has risen for four consecutive months and moved (barely) into expansion mode in November. Along with reduced U.S.-China trade risk (see bullet point five), this suggests the global economy may be on the rebound.



4) If inflation and inflation expectations remain at or below central bank targets, monetary policy is unlikely to tighten in 2020. Importantly, after the Federal Reserve's October 30 meeting, Fed chair Jerome Powell stated, "We would need to see a really significant move up in inflation that's persistent before we would consider raising rates to address inflation concerns." In subsequent weeks, several other Fed committee members echoed Powell, reinforcing the view that the Fed has set a high bar to raising rates in 2020. A quiet year on the monetary policy front would be welcomed by most investors.

5) Some key macro risks appear to have abated. A de-escalation in the U.S.-China trade war (the "phase one"

deal) should be positive for the global economy, business confidence, and overall market sentiment. In the United Kingdom, Prime Minister Boris Johnson's big election victory sets the stage for an orderly negotiated exit from the European Union (EU).

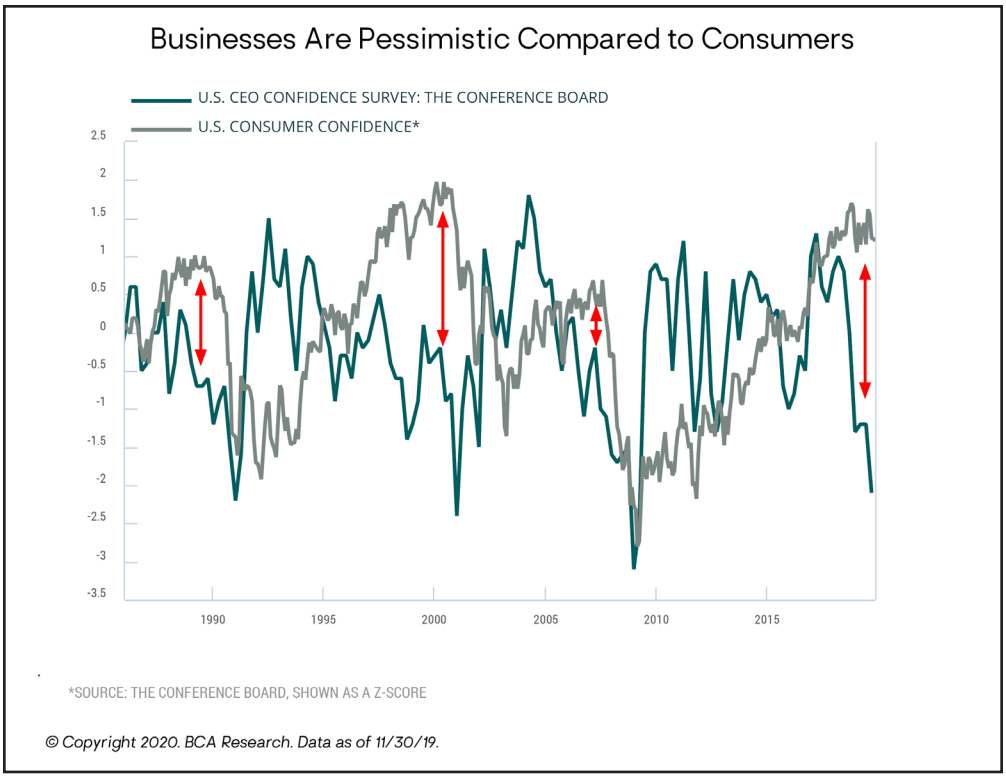
6) The U.S. consumer remains in good shape. Ongoing labor market strength, wage growth, and low interest rates should continue to support consumer spending and the housing market.

7) Fiscal policy may provide some (modest) additional economic stimulus in Europe, China, and Japan, and possibly the United States.

8) Financial market imbalances—the trigger for the past two U.S. recessions and bear markets—are not yet at the breaking point. Corporate and government debt are growing at an unsustainable pace. But, as long as the economy is also growing at a reasonable pace and interest rates don't rise too much, the debt/deficit chickens don't yet have to come home to roost. (Still, don't put all your investment eggs in one basket.)

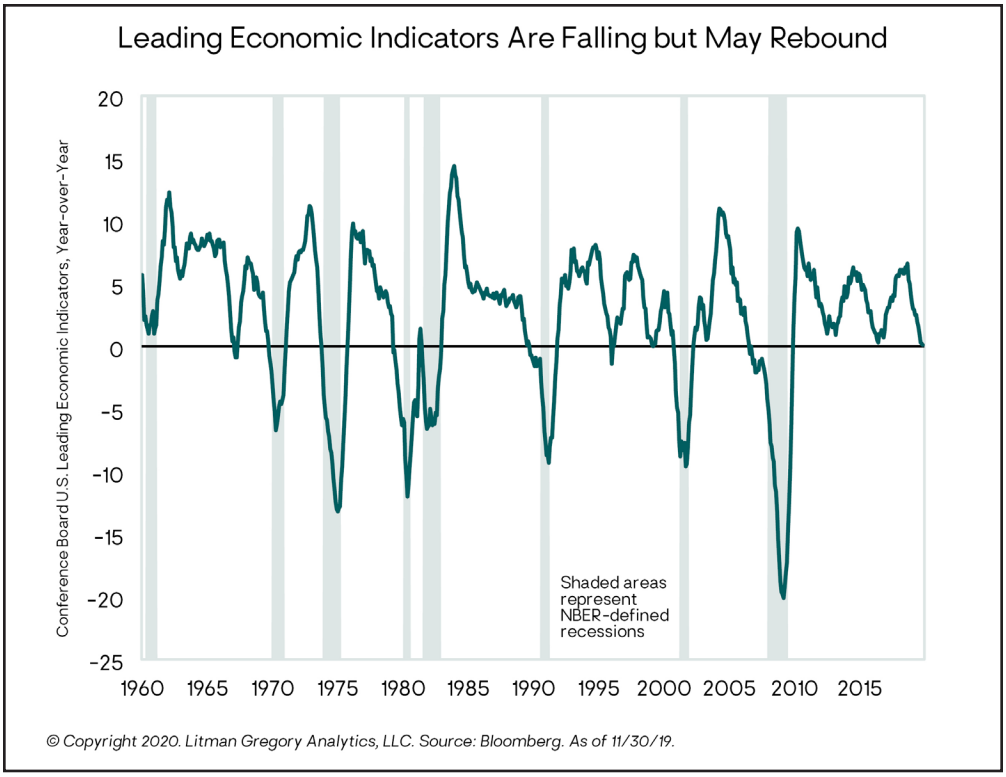
Some Key Market Risks in 2020

Overall, the economic and global macro backdrop appears to be turning to a modestly positive—or at least benign—trajectory for 2020. However, this is the consensus view as well. Financial markets have *already responded very positively* to these developments and the improving outlook. The risk of an unpleasant market surprise or deterioration in the macro environment in 2020 shouldn't be ignored.



1) **Valuation risk.**
For investors a critical question should always be, "What's in the price?" In other words, what economic assumptions and expectations are already embedded in current asset prices and valuations? From our vantage point, the U.S. stock market is *already pricing in* a supportive economic backdrop and sanguine macro view for 2020. With valuations stretched, the market is particularly vulnerable to disappointment or a negative surprise in any of these areas.

2) **The ongoing U.S.-China trade war.** Despite the recent positive developments, the U.S.-China trade war could reignite—we've seen this story before—or a different area of geo-economic conflict between the two countries could escalate. This would hurt a still-weak manufacturing sector, capital spending, and business confidence. In turn, this could lead to layoffs, dragging down the still-solid service side of the economy, triggering a full-blown recession as negative sentiment and risk aversion feeds on itself in a self-reinforcing cycle.



3) **Falling CEO confidence.** CEO confidence is already at recessionary levels and the year-over-year change in the index of leading economic indicators is getting close.

4) **U.S. election uncertainty.** Given the polarizing differences between the Republican and Democratic presidential candidates and their policy proposals, markets will likely be volatile depending on whether the incumbent Republican president Donald Trump, a moderate Democrat, or a further-left Democrat appears most likely to be elected. Control of the Senate is an additional wildcard. It's still way too early to say how the election will play out. A solid economy favors the incumbent, but Trump's low approval/high disapproval rating is a counterforce. Expect volatility as the markets discount each new political development in real-time right up to the election.

5) **Inflation surprises.** If inflation surprises to the upside (e.g., due to accelerating wage growth or a supply shock), central banks may be forced to tighten policy. This would be a negative shock for both core bonds and stocks. On the other hand, if inflation surprises to the downside, this may rekindle fears the economy is sliding into a recession—very bad for stocks, but good for core bonds.

6) **The yield curve indicator.** The Fed may have tightened too much in 2017 and 2018, and the lagged contractionary effects are still working their way through the economy. One consequence of Fed policy was the U.S. Treasury yield curve inverted for several months in 2019. An inverted yield curve has been a precursor to each of the past seven U.S. recessions. That the yield curve has now *un*-inverted doesn't mean the economy is in the clear as this pattern also happened prior to the 1990, 2001, and 2008 recessions. Put differently, Fed easing in 2019 does not guarantee the economy will avoid a recession in 2020.

7) **Brexit.** An orderly Brexit is not a done deal. There is still risk of a hard exit, "cliff-edge" scenario at the end of 2020 if the United Kingdom and the EU don't negotiate a new trade agreement by then.

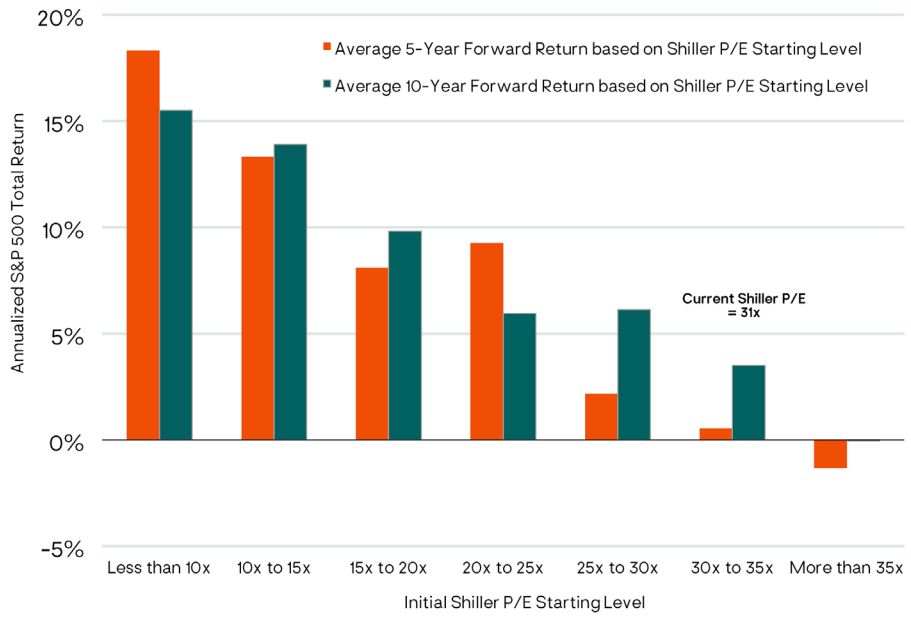
8) **Unexpected geopolitical risk.** There is always risk of an unexpected shock in the geopolitical realm (e.g., the Middle East, North Korea, China-Hong Kong, or some other area off most investors' radars).

Opportunities and Risks Over the Medium Term

Looking beyond the next 12 months, over a medium-term (5–10 year) time horizon, the range of outcomes is still wide, but our confidence around our base case is higher. We see significant headwinds to the performance of both U.S. stocks and core bonds. The downside risk relative to their potential return is high. Hence, as noted above, we

are tactically underweighted to both asset classes.

U.S. stocks sport the unappealing combination (from a *forward-looking, return-on-investment perspective)* of high valuations, in conjunction with high profit margins, and above-normal earnings. History, economic logic, and our scenario analysis strongly suggest this isn't a sustainable state of affairs. The business cycle and the market cycle haven't been repealed.



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However, we also know momentum and sentiment (driven by central bank liquidity) can extend the current trend still further. Many investors seem to be of the mindset that, "as long as the music is playing, you've got to get up and dance," as Citigroup's ex-CEO infamously said in July 2007. (Presumably, they also believe they will be able to slip out the emergency exit ahead of the crowd just before the party gets shut down.)

Said differently, valuation is worthless as a *short-term* market-timing indicator. Overvalued markets can get even more overvalued in the short-term due to investor optimism, greed, and euphoria. The 1999–2000 tech stock bubble is an extreme example.

But valuation—the price you pay for an expected future stream of cash flows—is a hugely important driver of investment returns over the medium to longer term. For example, the Nasdaq index had an *annualized loss* of 6.3% in the *10 years* following its March 2000 peak. And it didn't reclaim that peak level until mid-2015, more than 15 years later.

Valuation is not 100% determinative of future returns. Nothing is. But it's a very strong indicator, as shown in the chart below. (Note: The chart uses the Shiller price-to-earnings ratio, where earnings are a 10-year average adjusted for inflation. Our internal valuation analysis is not based on the Shiller P/E or any single valuation metric. But the Shiller P/E is well-known and captures the longer-term relationship between starting valuation and future return reasonably well.)

With U.S. stocks expensive and high risk, we continue to see better investment opportunities elsewhere: in foreign stocks, flexible bond funds, and selected alternative strategies.

European and EM stocks are a kind of mirror image of the U.S. market. They've been out of favor for several years and look relatively cheap on still-depressed (below normal) earnings. Our base-case five-year return outlook for both markets is several percentage points higher than for U.S. stocks.

In the shorter term, should the positive global growth outlook for 2020 play out, we'd expect international and EM stocks to outperform U.S. stocks, given their higher cyclicality and sensitivity to overall GDP growth. To the extent

the U.S. dollar weakens in this environment—due to it being a *counter*-cyclical currency—that will further help foreign stock returns (for dollar-based investors).

Core bonds' very low starting yield implies very low expected returns over the next five years. Nevertheless, in our conservative portfolios we still maintain meaningful exposure for risk management purposes.

However, flexible bond funds and alternative strategies run by skilled managers are particularly attractive in this low-return/high-risk environment. We own funds run by investors with the expertise to actively manage their portfolio risk exposures (e.g., dialing down risk when the reward is not commensurate) and the ability to take advantage of market inefficiencies and opportunities when they appear. Not only do these strategies provide valuable portfolio diversification, but we also expect them to deliver better medium-term returns than a traditional mix of U.S. stocks and core bonds.

These tactical opportunities are relatively attractive, but none of them are without their own risks. There are few table-pounding, valuation-based fat pitches in the investment markets these days. Ten-plus years of unprecedented central bank stimulus and interest rate repression have inflated the prices of most financial assets … if not the actual global *economy*.

Given this backdrop—weighing the shorter- and medium-term risks and return opportunities and considering the economic fundamentals against market valuations—we think the wisest course for balanced investors continues to be a broadly diversified, moderately defensive posture.

Closing Thoughts

The economic consensus seems to be for decent global growth in 2020 and accommodative central bank policy. This would be a supportive environment for stocks and other financial assets. However, to some extent this outlook is already reflected in current market prices—at least for U.S. stocks—especially after the sharp year-end rally.

High valuations and excessive optimism make asset prices more susceptible to negative surprises. The U.S. election and evolving or unexpected geopolitical risks may be the key drivers of market volatility in 2020.

As we said earlier, we don't make 12-month market forecasts. The uncertainty is too high and the unknowns too many. Market history shows the range of outcomes over such a short time frame is extremely wide.

In our 2018 year-end commentary, we wrote, "No one knows what next year will bring. We may see some continuation of recent market trends or a stabilization or reversal in some of them. The market consensus will undoubtedly be surprised again. *The only certainty is the lack of certainty*."

That turned out to be a pretty good forecast for 2019. We'll stick with it again for 2020.

More important—and most relevant for our investment process—is our outlook for the next several years not months. In this respect, our assessment of the risks and opportunities remains consistent with what it's been in recent years.

Our portfolios are built to be resilient across a range of macroeconomic scenarios. They are positioned to withstand a severe market downturn (consistent with each portfolio's specific risk objective). Yet they also provide tactical exposure to asset classes, strategies, and managers we believe currently offer attractive total-return potential over the medium-term (and longer) horizon.

We also remain ready to shift from a relatively defensive to a more offensive posture when market volatility (e.g., a bear market) provides us the opportunity to add to U.S. stocks at much lower prices and much better expected returns. We may or may not get that opportunity in 2020. It may come in 2021. Or 2022. We don't have to predict when. We follow our investment discipline. We're confident it will serve us and our clients well, as it has over the past 32 years.

As always, we appreciate your confidence and trust in Litman Gregory. We wish everyone a happy, healthy, and peaceful New Year.

—Litman Gregory Investment Team (1/7/2020)

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