Perspectives

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Market Recap

Wow, what a year! Let's start off this year-end edition of Perspectives by giving thanks. Thanks for the wonderful returns in both the stock and the bond markets; thanks for the great economy that we are enjoying; thanks for historic low unemployment and inflation rates; and thanks for a truce in the trade wars (at least a Phase 1 deal). Most importantly, we give thanks for all of our wonderful, faithful clients who have placed their trust in us! Yes, it was a very good year!

After experiencing the best first three quarters of a year since 1997, the stock market continued to rise in Q4, however, it could not keep up the torrid 1997 pace. Nevertheless, the S&P 500[1] returns this year were the best since 2013 – up 30.4%.

As we progressed through the quarter, three things stood out. First, the stock market rally broadened out, with nearly everything doing well. Second, it became apparent that the Federal Reserve is not going to raise interest rates any time soon (possibly not until after the 2020 elections), and it is not likely to cut them, either. Finally, Charles Schwab cut its brokerage commissions on stock trades to zero, and most of its competitors followed. We believe the commission cuts, which removes a great deal of "friction" from trading, is having a significant effect on the stock market, but it is too soon to discern exactly how it is effecting markets. The effect will be more evident as we move through 2020.

The U.S. bond market performed unusually well, with the U.S. Aggregate bond index[2] up 8.7% in 2020. That is quite remarkable for bonds.

Foreign stocks had a good year also, with developed markets[3] up 22.7% and emerging markets[4] up 18.9%. These returns were not as good as those in U.S. markets, but were very respectable, nonetheless.

Even commodities were able to put up positive returns - up 5.4%, after years of dismal returns.[5] Shale production technology (invented in the USA!) has proven to be a game changer. The effect of new supply far exceeding demand growth has put a lid on oil prices for the most part over the past few years. Will 2020 be any better for commodities than 2019? It is hard to say, though the trade truce, and likely more farm aid leading up to the election, should provide a floor to prices.

Forecast

In Perspectives one year ago, we said we thought that in 2019 the stock market would be up about 7%, if the price/earnings ratio stayed the same - and up about 14% if that ratio rose to its 25 year average.[6] However, the price/earnings ratio rose even more than we thought, and that accounted for the huge year in the U.S. stock market in 2019.

The U.S. stock market valuation now seems to be somewhat overvalued relative to historical valuations. For example, the current valuation of the U.S. stock market on a price-to-sales measure, is higher now than what it was in 2000, the year of the dot-com crash. However, easy money from the U.S. Federal Reserve gives us confidence that the economy will continue to expand and that stocks should continue to rise in 2020 despite the ongoing trade issues and current stock market overvaluation.

We believe U.S. corporate earnings will rise around 6% in 2020. Therefore, if the price/earnings ratio stays the same, the stock market should be up 6-9%, dividends included. However, it would not be unusual for the price/earnings ratio to overshoot its historical average, resulting in a stock market increase of 15-18% in 2020. In fact, if you go back to 1980, there have been 12 years when returns were 20% plus. In three of those instances, the stock market was down the following year and the average decline was 9%. In nine of those instances (75% of the time), the stock market followed those plus 20% years with positive returns that averaged 16.6%![7] That could be the kind of year we have in 2020.

In the rest of the world, it appears that global growth is starting to improve. This is especially true in Europe. We continue to believe that global manufacturing bottomed out in the summer of 2019, and we expect to see it recover in 2020. Not only are international stocks cheaper, with global growth accelerating, the returns should be higher than what might be available in the U.S. going forward.

We expect the U.S. bond market to be flat in 2020. Of course, it has been nearly impossible to predict interest rates with any degree of success in recent years, however, we expect interest rates on the 10-year U.S. Treasury to trade in a range from 1.50% - 2.25% in 2020. The rate was 1.92% at the end of 2019.

Impeachment will be a first quarter issue in 2020. We do not expect it to have much of an effect on financial markets, as it is not likely to affect corporate earnings in any significant way. The elections will be front and center in the second and third quarters, however, once again, we do not see much of an effect on the markets unless a far left candidate emerges as a very viable opponent for the incumbant. The trade wars seem to have subsided for the time being, and, although it could rear its ugly head again, we don’t think there is much appetite for a resumption. However, there is a possibility that President Trump will decide to step up the trade fight with Europe.

What is likely to roil markets in 2020 is some kind of geo-political event, or, a surprise change in U.S. policy that affects corporate earnings or knocks the feet out from under consumer confidence. What we can say with certainty is that markets will always have something to worry about. That is just what markets do!

Portfolio Management

Every day we work hard to give our clients the very best portfolio performace we can, given our desire to manage portfolio risk, yet do what we need to do to meet our client’s goals (including preserving capital). We strive to maintain a balanced approach to investing in order to preserve client capital.

One way we can add to performance over time is to keep a watchful eye on portfolio expenses (keep in mind that stock market indexes do not have expenses – they are just paper portfolios - and do not reflect real life investment returns). Schwab cutting commissions to zero last fall is a good step in the right direction, and was very welcome (they still charge commissions for mutual fund trades).

As our clients know, mutual funds charge expense ratios, which compensates them for what it costs to manage a mutual fund, all of the trading costs, the marketing costs, and a profit. These fees are usually from ½% - 1½%, though they can be much higher. At BFSG, we pay particular attention to these expenses and, as a result, the weighted average of the expense ratios in the funds we buy for you are about .50%.[8] We utilize low-cost institutional share class funds when appropriate, to reduce the expenses in your portfolios. We are always looking for opportunities to save a penny here or there.

We also use exchange-traded index funds (ETF’s) where we can, and where it is appropriate. These ETFs often carry lower expense ratios than mutual funds, allowing us to further reduce our average expense ratio. This type of fund has some characteristics that we don’t care for, so we use them judiciously, but they do help us to bring down our weighted average expense ratio for your benefit.

We are very proud of the work we have done to keep portfolio management expenses as low as possible. In a recent review for a prospective client, we were able to offer a suitable portfolio for the client that would save him nearly 2% per year in expenses vs. what his broker was going to charge him. We promise to continue squeezing out expenses wherever we can in your portfolio.

News Flash

Michael Allbee, CFP® has been promoted to “Partner” at BFSG. Mike is a Senior Portfolio Manager and our Chief Compliance Officer. He is also a Ceritified Financial Planner™. Mike has been with us for nearly 13 years, and those of you who work with him know how deserving he is of this recognition of his value to our firm.

We now have eight partners at BFSG. John Campbell is a Managing Principal of our Institutional Services division (corporate retirement plans). Parick Powers, Grace Lau and Dr. Steven Yamshon are Managing Principals of our Wealth Management division.

In addition, we have three other partners in Institutional Services (Darren Stewart, Chris Rowey, and Tina Schakman) – and now Mike Allbee in Wealth Management.

Please join us in welcoming Mike into our partnership. It is a big event for Mike, and also for our firm!

The Score Board

	12/31/2019	YTD Change
Dow Jones Industrial Average	28,538.44	22.3%
S&P 500*	3,230.78	28.9%
NASDAQ Composite*	8,972.60	35.2%
MSCI EAFE (USD)*	2,036.94	18.4%
Bloomberg Commodity Index	80.89	5.4%
Barclays Aggregate Bond Index	2,125.00	8.7%
10 Yr U.S. Treasury Bond Yield	1.92%	-77 bps
30 Yr Fixed Mortgage Rate	4.02%	-58 bps
Prime Rate	4.75%	-75 bps
Crude Oil ($ / Barrel)	$61.06	34.5%
Gold ($ / Oz.)	$1,519.50	18.9%
Euro € / U.S. $	$1.12	-2.2%
Core Inflation (excluding food / energy)		2.30%**
Inflation (including food / energy)		2.10%**

**Without Dividends*

***Unadjusted 12-Months ended November 2019*

bps (1 Basis Point = 1/100%)

UNCH (Unchanged)

Sources for Score Board and quoted statistics:

WSJ, US Dept. of Labor, Federal Reserve

Sources:

1. The S&P 500 is designed to be a leading indicator of US equities and is commonly used as a proxy for the U.S. stock market. Total return quoted.
2. The Barclays Aggregate Bond index is a broad-based index used as a proxy for the U.S. bond market. Total return quoted.
3. The MSCI EAFE index captures large and mid-cap segments in 21 developed markets around the world, excluding the US and Canada. Total return quoted (USD).
4. The MSCI Emerging Markets index captures large and mid-cap segments in 26 emerging markets. Total return quoted (USD).
5. The Bloomberg Commodity index is a diversified benchmark for commodity investments.
6. Source: FactSet, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management. Price to earnings (P/E) is price divided by consensus analyst estimates of earnings per share for the next 12 months as provided by IBES since December 1994, and FactSet for December 31, 2019. Average P/E is calculated using 25 years of IBES history.
7. Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management Guide to the Market. S&P 500 returns are based on price index only and do not include dividends from 1980 to 2019.
8. The weighted average expense ratio of 0.53% was calculated for a BFSG model portfolio with 70% stocks and 30% bonds using Morningstar Direct (as of 9/30/19).

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