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"Every bull market must have a wall of worry on which to climb." –Wall Street proverb

2019 represented a banner year for investors across most major asset classes. The strong returns of stocks and other risk-based assets were driven by attractive starting valuations, accommodative monetary policy, and the easing of trade and geopolitical tensions. At the same time, falling interest rates caused by recession fears provided a tailwind for bonds, as bond prices move opposite rates.

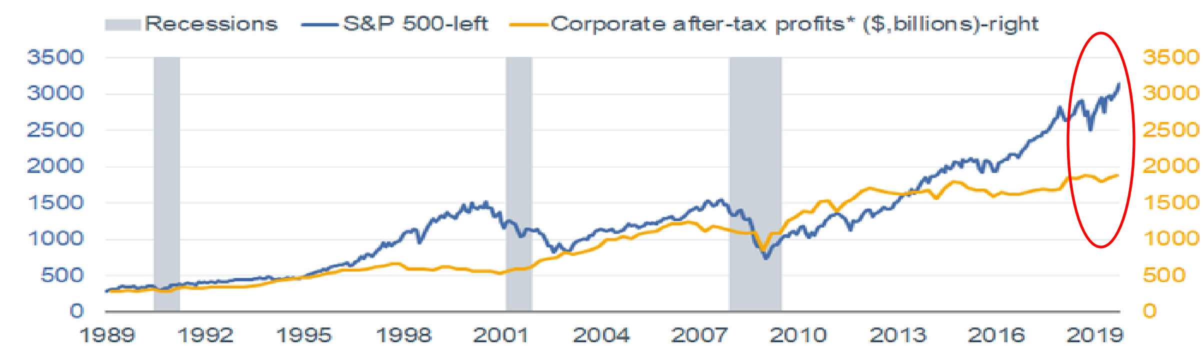
Annual Market Summary: 2019 Index Returns

US Stock Market	Developed ex US Stocks	Emerging Markets Stocks	Global Real Estate	US Bond Market	Global Bond Market ex US
Stocks				Bonds	
31.02% ↑	22.49% ↑	18.42% ↑	23.12% ↑	8.72% ↑	7.57% ↑

Source: Dimensional Fund Advisors

The significant market decline in late 2018 resulted in below average valuations for most broad stock indices. At the beginning of 2019, the S&P 500 was priced at 14.4x earnings compared to the 25-year average of 16x earnings. This discount helped bring buyers into the market. Fast forward 12 months, and the S&P is now valued at 18.2x earnings—the result of prices going up at a much faster rate than earnings. This pace of multiple expansion is unlikely to be sustainable over longer periods, especially from current levels. Earnings will therefore need to improve for the market to move meaningfully higher from here. 2019 reported profits have been relatively flat due to a stronger dollar, supply chain disruptions, higher import costs from tariffs, and increased unit labor costs. The current above-average gap between price and earnings can be seen in the chart below.

S&P 500 Change in Price versus Change in Earnings

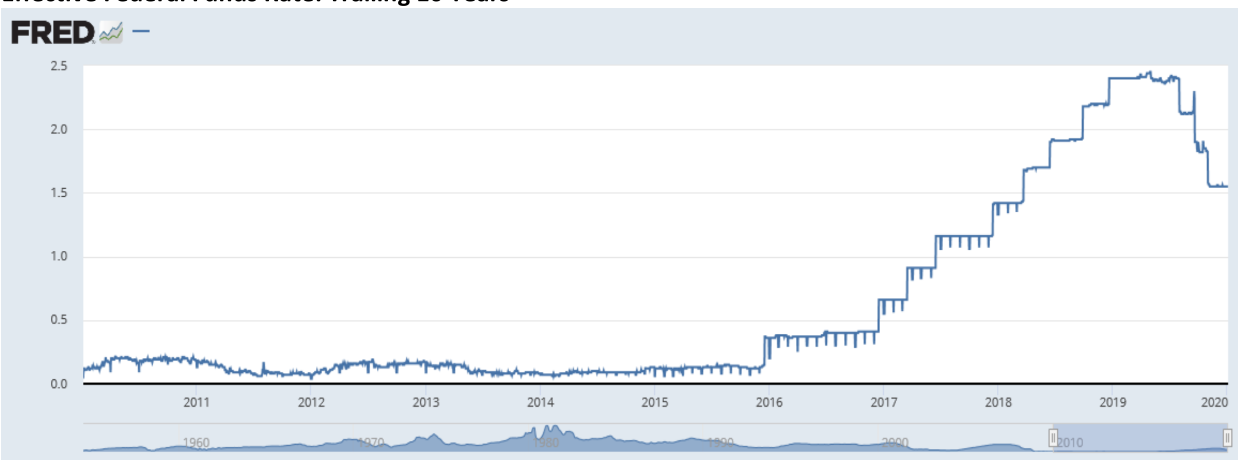


Source: Charles Schwab; profit levels not shown on a per-share basis

Easier monetary policy played a key role in the performance of risk-based assets in 2019. Elevated recession fears and muted inflation led the Federal Reserve to cut rates for the first time since 2008. The Fed lowered rates by .25% three times between July and October in an effort to sustain the current economic expansion. This helped boost "risk-on" sentiment in the market and drove stock prices higher.

The chart below provides a visual summary of monetary policy since the 2008 financial crisis. For much of the last 10 years, the Fed employed a zero interest rate policy in order to stimulate growth and support prices (2009-2015). This was followed by a period of policy normalization where the Fed raised rates by 2.25% over a 3-year span (2015-2018), before the renewed easing described above (2019). The Fed remains data dependent, but is currently expected to leave rates unchanged over the next 12 months.

Effective Federal Funds Rate: Trailing 10 Years



Source: Federal Reserve Economic Data as of January 2020

Rate cuts in 2019 steepened the yield curve in the fourth quarter and reversed the period of inversion (where shorter maturities yielded more than longer maturities) that occurred earlier in 2019. An inverted yield curve has historically been among the most reliable forecasters of recession, but with a variable lag of 18-24 months on average. We note that the typical pattern associated with the yield curve signal follows the order of 1) inversion, 2) rate cuts, 3) steepening, 4) recession. We don't believe this time will be different. A recession will occur at some point, but no one is able to predict the timing or severity with any certainty.

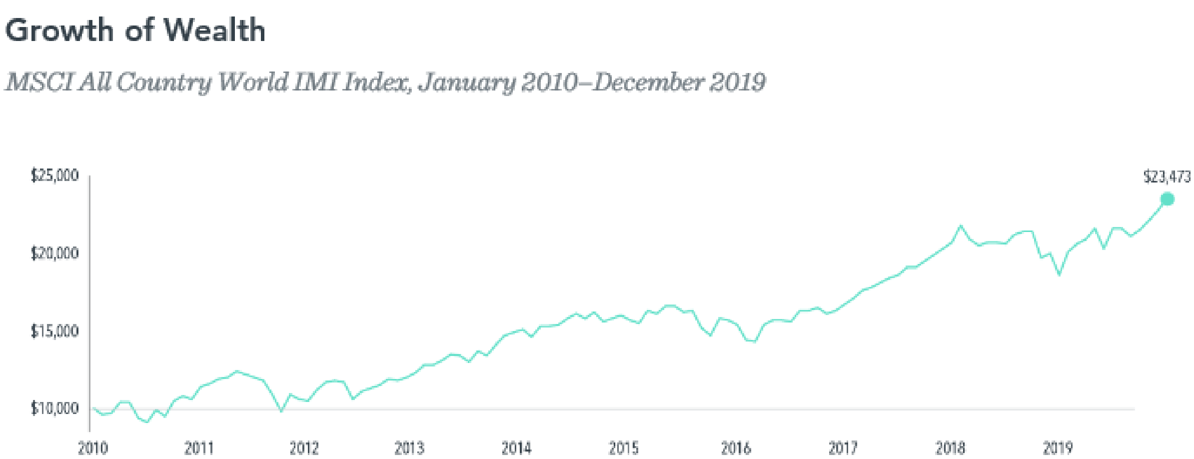
U.S.-China trade war headlines were a constant source of market ebb and flow in 2019. The year ended on a positive note with the announcement in mid-December of a "Phase 1" trade agreement. While the deal appears to be limited in scope and somewhat lacking in substance, it represents at least some degree of formal progress and reprieve after nearly two years of failed talks.

The agreement cancelled additional U.S. tariffs on popular consumer goods that were scheduled to go into effect during the holiday shopping season and rolled back the rate on a subset of existing tariffs. U.S. tariffs of 25% remain on $250B in Chinese goods including machinery, electronics, and furniture. In return, China cancelled its planned December retaliatory tariffs on U.S. made goods, including a 25% tariff on U.S. autos. In addition, the Chinese agreed to increase purchases of U.S. farm products and other key exports in an effort to reduce the current U.S. trade deficit with China.

Phase 1 may provide a lift to business confidence and capital spending going forward, helping to support GDP growth. The deal also reduces the risks of tariff-related price increases on consumer goods more broadly. The agreement does not meaningfully address some of the more contentious issues related to intellectual property protection and forced technology transfer. These issues are expected to be a bigger focus of "Phase 2" negotiations scheduled to occur in 2020.

December brought positive news on other fronts as well, including a new trade deal between the U.S., Mexico, and Canada known as USMCA. The agreement represents a modernized version of the 25-year old North American Free Trade Agreement. USMCA has bipartisan Congressional support and is expected to be formally approved in January. Finally, December parliamentary elections in the UK gave Boris Johnson and the Conservative Party a majority win and a mandate to finally get Brexit done. Johnson has pledged to take Britain out of the European Union by January 31, 2020. These cumulative events eased geopolitical tensions and reduced uncertainty, helping to deliver a 2019 Santa Claus rally instead of the lump of coal investors received in 2018.

Taking a longer view, investors who stayed the course coming out of the global financial crisis have been significantly rewarded over the past decade. On a total return basis, global stocks more than doubled in value over the period, returning 8.9% on an annualized basis (see chart below). U.S. stocks did even better, with the S&P 500 returning 13.5% on an annualized basis compared to its long term average of 10%. These returns occurred despite six drawdowns ranging from 10% to 20% and major events such as the sovereign debt crisis in Europe, the U.S. credit downgrade, negative interest rates, inverted yield curves, the Brexit vote, U.S. elections, trade wars, ballooning federal and corporate debt, and turmoil in the Middle East. We are reminded that the equity risk premium is earned through staying invested.



Source: Dimensional Fund Advisors. Index includes developed and emerging market stocks.

Looking forward, we think it unlikely that the returns from capital markets over the next decade will match returns from the last decade. Historically, the returns for stocks over longer periods are significantly influenced by starting valuations, and the return for bonds are highly correlated to beginning yields. Current above-average valuations for U.S. stocks imply below-average forward returns. Likewise, low current yields for bonds lowers the future return expectations for that asset class. Many institutional investors currently expect the average 60/40 portfolio of global stocks and bonds to return in the range of 4.5% to 6% on an annualized basis over the next 10 years. This compares to 7.5% average returns for balanced portfolios over the last three decades. Based on this outlook, we have incorporated more conservative assumptions into our financial planning process.

While future returns are unknowable, we will continue to invest in diversified portfolios of assets where we see the greatest potential for positive risk-adjusted returns. Over the long term, we believe such an approach will be rewarded.

The Private Capital Management Team

By the numbers…

Index	2019
S&P 500	31.49%
Dow Jones Industrial Average	25.34%
Russell 2000	25.52%
MSCI EAFE	22.01%
MSCI Emerging Markets	18.42%
Barclay's US Aggregate Bond	8.72%
Bloomberg Commodity	7.69%

Source: Morningstar as of 12/31/2019