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~OUR CHIEF INVESTMENT OFFICER'S COMMENTARY~

This past year was remarkable for both the performance of the financial markets as well as the improved outlook for global economic growth. As the year began, the stock market rallied from the oversold sentiment which prevailed at the close of the prior year, a sentiment which incorrectly anticipated the global economy would be severely disrupted by tariff barriers to trade. Although manufacturing slowed early in the year, the slowdown never fully morphed into a recession in the United States, due to its strong service sector. **High employment, wage growth, and consumer spending became the pillars of continuing expansion.**

By midyear, fanned by blaring commentary about recession and trade war, the gloom became palpable. On a daily basis, the progress, or lack of progress, characterizing the logistics of future discussions with China moved seasonally illiquid markets. Nothing economically meaningful in the headlines, mind you, just rumors and speculation about the agenda for continuing discussion. Summertime is traditionally a time of sparse economic news. After second quarter earnings were released in July, there was little additional substantive financial news reported, until September; the low volume, thinly traded stock market simply reacted to headlines during the summer months.

While investors and the media focused on trade, it was almost ignored that 2019 marked the fastest pace of coordinated central bank easing since the financial crisis a decade earlier. The effect of this easing supported dramatically lower government bond yields and cushioned the impact of contracting global manufacturing, faltering business confidence, and slowing capital investment. These actions effectively support future global growth and stem the risk of near term recession. The ensuing robust recovery in equities and corporate debt leave an impression of better times ahead for economic activity and corporate profits, but the support of central bank easing should not be underestimated. **Both the Federal Reserve Bank and the European Central Bank have sent a message that monetary policy will remain in an easing mode for the foreseeable future. This alone should assure a longer economic cycle.**

A sustained low yield environment favors equities, and riskier areas of credit, as investors evaluate the equity yield spread more from the perspective of a decline in benchmark bond yields, such as the ten year U.S. Treasury, than from an improvement in the equity earnings yield. **In other words, even if earnings growth remains constrained, equities will continue to be attractively valued investments as long as benchmark bond yields remain low. In this scenario, with equity valuations linked to bond yields, investors should expect somewhat greater volatility in the stock market as interest rates are expected to be volatile.**

But, global growth should begin to accelerate in the coming year, further favoring stocks over bonds. Those economies which have been teetering on the brink of recession could produce better equity returns than found in U.S. equities, since they have more potential for profit margin improvement. Bond yields should rise modestly due to increased demand for borrowed funds due to an improved outlook for economic growth. In this scenario, the dollar will probably weaken against most currencies, further contributing to the outperformance of non-dollar investments. **The dollar is a counter-cyclical currency in that, when global growth strengthens, capital tends to flow out of the U.S. to those economies with greater exposure to manufacturing and commodities; i.e. industries with opportunity for margin improvement.**

Since our forecast is contingent on support from central banks, the question which confronts us is when and how the debt super-cycle will end. As mentioned, in the near term, we expect bond yields to rise modestly as global growth accelerates. However, in the longer term the increase in yields will depend on whether inflation returns. The high debt levels, resulting from artificially low interest rates, could actually become deflationary, if it curtails future spending. These high debt levels could prompt central banks to engineer higher inflation in order to reduce the real burden of debt obligations. Policy makers will tend to favor inflation since high unemployment and fiscal austerity are politically toxic. Thus our longer term forecast continues to lean toward overheated economies with rising inflation. However, we do not expect this to occur in the near-term investable future. Since interest rates tend to stay lower longer than the economy needs to reach full employment, **central banks will refrain from tightening monetary policy until inflation rises well above their comfort zone; this will be positive for stocks, as long as it lasts.**

Uncertainty over the U.S. election may also limit the gains available to equities in the coming year. Glaring headlines and angry rhetoric will cast a psychological pall over the markets. The current Democratic front-runners have pledged to roll back the 2017 Tax Cuts and Jobs Act, the full repeal of which would reduce S&P earnings by about 10%. While this, along with threats of increased regulatory actions, is far from guaranteed, it does pose a risk to investors.

While 2019 was an exceptional year for financial asset returns, it would be foolish to expect similar returns for 2020. **We do remain optimistic that equities will trend higher as the U.S. economy continues to grow; lifted, instead of hampered, by global growth.**

Fixed Income

Compared to a year ago, the fear of restrictive monetary policy slowing economic growth has reversed, and monetary policy has eased considerably. The Fed lowered rates by 25bps for the third time in late October and left the Fed Funds target rate unchanged at 1.50% - 1.75% following its final meeting of the year. The looser monetary conditions and improving economic data suggests the Fed will remain on hold for the foreseeable future. The current policy stance is "likely to remain appropriate," with Fed officials setting a high bar for rates to be further lowered and extremely cautious of raising rates in the near term.

The target rate is expected to remain on hold for a few reasons. First, Fed officials will be sensitive to the political pressures of raising interest rates ahead of the 2020 election and will avoid having a policy response over escalating or easing of trade tensions between the U.S. and China. Second, the Fed is expected to be extremely cautious of raising interest rates too quickly in the event that inflation would start to rise. After a decade of below-target inflation, Fed officials have indicated they would allow inflation to persist above the 2% target for a while before beginning to raise interest rates again. Chair Powell has stated there would need to be a "significant move-up in inflation that's persistent" before raising rates again. **In this scenario, an extended period of low rates that helps to support economic growth will persist much longer despite the path it creates for higher inflation.**

The yield curve has "un-inverted" and the inversion warning over the past year most likely overstated the risk of economic contraction. Restrictive monetary policy that increased short-term rates has been replaced by target rate cuts that have moved short-term yields lower relative to long-term yields. Although the risks from tightening have subsided, we continue to evaluate the many factors that may signal the next potential slowdown. Historically, wider credit spreads, the difference in yield between a corporate bond and a Treasury of the same maturity, have also been a reliable leading indicator of slowing economic growth. Wider spreads often result from perceived increased risk of default by borrowers and reflect the reluctance of lenders to extend credit. In this situation, a widening of spreads may deprive funds from less credit-worthy borrowers, resulting in slower capital spending and hiring by companies, and ultimately leading to a slowdown in economic growth. **While corporate bond spreads have remained low, we are watching this as a leading indicator that may prove to be an important signal of where the economy is headed should spreads start to widen in the year ahead.**

International Market

The international markets underperformed the U.S. domestic market during 2019, but, late in the year, the two dark clouds which have overshadowed the international equity markets in recent years began to dissipate. **As positive developments arose from both Brexit and the trade treaty renegotiation between the U.S. and China, a new sense of direction began to boost investor confidence.** Even though we have long emphasized these two issues have little effect on economic and market fundamentals, progress has encouraged market psychology.

With Brexit, the key concern has been the possibility that the United Kingdom (U.K.) would leave the European Union (E.U.) without a withdrawal agreement. However, that uncertainty was resolved by the election held in early December. The Conservative Party led by Prime Minister Boris Johnson won the U.K. general election with a larger-than-expected majority. It now looks very likely that the Brexit deal Johnson negotiated with the E.U. earlier this fall will pass in British Parliament, and that the U.K. will formally leave the E.U. before January 31st. **A clearer path towards a resolution to Brexit will boost consumer and business confidence, and improve the outlook for economic growth.**

The current Brexit deal calls for the future trading relationship between the U.K. and the E.U. to be negotiated during the transition period, during which the U.K. will de facto remain in the E.U. However, the Conservatives have pledged not to extend the status quo beyond the current December 2020 deadline, and to reach a trade agreement before then. Therefore, if a deal isn't agreed by December 2020, and the transition period isn't extended, trade between Great Britain and the E.U. would revert to World Trade Organization terms, effectively a "no deal" scenario. We consider that possibility to be slim; with a widened Conservative majority, the government is less beholden to the hardliners. **If needed, we believe that Johnson will backtrack and ask for an extension, eventually leading to an orderly exit from the E.U.**

Recent news that the U.S. and China have agreed on a deal in which Washington scales back tariffs in exchange for Beijing buying more U.S. agricultural and other products has raised hopes of a lasting breakthrough to end the "trade war." The "Phase One" trade deal calls for the U.S. to cut tariffs imposed in September on $120 billion of goods from 15% to 7.5%, and in return China will also lower existing tariffs, strengthen intellectual property protections, and open up its financial sector to U.S. firms. **Most significantly, China will boost purchases of U.S. products by $200 billion over two years, with significant increases in agricultural goods.**

Aside from the psychological aspect of improving investor confidence, we see real economic benefit from these developments as limited. Just as we opined in the past that added tariffs would not have meaningful economic impact, and the data showed little effect on consumer prices or real incomes at the aggregate level, for the same reason, the removal of the tariffs also have similarly insignificant impact. Nonetheless, this deal sets the stage for a truce and we welcome this positive development. What comes next is more important as we believe the trade treaty renegotiation process will move to a new and more difficult phase in the year 2020. **The focus will shift away from tariffs and towards a broader set of issues on which China is less likely to budge, for example, technology, industrial policy and security. We think these discussions will continue for many years.**

In addition to relieving concerns that have weighed on investor confidence for some time, policy makers around the world have also introduced market friendly policies that should have fundamental impact on the global economy. As stated earlier, we have observed "the fastest pace of coordinated central bank easing since the financial crisis a decade earlier," including rate cuts by the Federal Reserve and the European Central Bank, the early conclusion of so-called "quantitative tightening" in the U.S., and the relaunch of quantitative easing in the euro-zone. These actions have helped to buoy stock markets, lower bond yields and reduce credit spreads in 2019, and are likely to continue into 2020. Looser financial conditions typically prompt banks to relax lending standards, resulting in more accommodative credit conditions which benefit both businesses and consumers. **With the boost from this year's loosening in financial conditions, we believe the global economy will likely rebound further in the new year. Hence, we continue to believe, depending on investors' risk tolerance, that exposure to the international markets is warranted.**