Market Review and Outlook—January 6, 2020

Rising Tide Lifts All Boats—Last January's **Market Review and Outlook's** results table looked quite different; every stock category had a loss in both the **3–** and the **12-Months** columns, and even **Intermediate Term Bonds** had a 12-month loss. This report shows not a single loss. After a horrid 2018 fourth quarter for investors, 2019 brought a year for the record books, for both stock and bond investors.

What Goes Down Must Come Up—As I noted in the Outlook portion of last January's report, back-to-back losses are very uncommon for the US stock market. Put another way, 2019 began with stocks in a trough. PE levels, a measure of how expensive stocks are, were 11% cheaper than average. While investors had much to worry about (led by concerns over rising trade tensions, and the end of the tax law change short-term high), this was reflected in the fairly cheap level of stocks. In 2019 the US economy continued to grow, albeit at its ongoing sluggish rate, and there are no clear signals that the economy will stop growing in 2020. While the trade war hasn't been resolved, by the writing of this review, it appears that a framework for a resolution is in reach. The Fed surprised many in cutting the overnight rate three times in 2019. Not only do the positive developments in 2019 outnumber the negative ones, but most of the negative ones were priced into the market at the start of the year.

It's Foreign to Me—2019 saw US stocks lead foreign stocks the eighth time of the decade, however one should never have to apologize for a one-year gain of 20% or more. The rising trade tensions during most of the year led the US dollar to strengthen, which cut into foreign stock results.

Surprising Strength from Bonds—2019 expectations for bonds were low. The economy was expected to continue to limp along but avoid a recession. Interest rates were expected to be stable, but instead rates fell and bond prices rose. Longer-term quality bonds and opportunity bonds such as high-yield bonds did the best in 2019.

Economic Yardsticks—GDP slowed from 3.0% to 2.1% during the year (3Q18 to 3Q19). Unemployment fell slightly to 3.5%, while wage growth rose nicely to 3.7%. Inflation was pretty flat at 2.2%. The US dollar rose 4.7%. Oil prices bounced back 34.7%, after falling 29.6% in 2018.

Recap—2019 brought surprisingly strong gains for both bond and stock investors. The gains were so strong that 2020 is very likely to bring quite different results than its predecessor. After a year as profitable as 2019, we recommend that investors re-examine and rebalance their portfolio, to cut back on the risk that naturally builds during big gains. We also recommend re-examining future prospects, given the much higher starting market levels.

Category	3 Months	12 Months	3-Yr Avg	5-Yr Avg	10-Yr Avg
Fidelity Cash Reserves	+0.36%	+1.90%	+1.32%	+0.81%	+0.42%
Intermediate Term Bond	+0.11%	+8.04%	+3.58%	+2.71%	+3.54%
Intermediate Muni Bond	+0.53%	+6.87%	+4.05%	+2.89%	+3.70%
Large-Cap Stock	+8.14%	+28.83%	+13.29%	+9.80%	+12.05%
Mid-Cap Stock	+7.06%	+26.12%	+9.10%	+7.09%	+11.03%
Small-Cap Stock	+7.98%	+23.75%	+6.82%	+7.10%	+11.15%
Foreign Large-Cap Stock	+8.38%	+21.61%	+9.08%	+5.36%	+5.14%
Health	+18.74%	+26.38%	+16.05%	+8.82%	+14.93%
Real Estate	+0.64%	+27.27%	+8.34%	+6.79%	+11.29%
Technology	+11.87%	+37.16%	+21.60%	+16.28%	+15.04%
Moderate Allocation (60% stocks)	+5.01%	+19.20%	+8.54%	+6.22%	+7.89%

The data in this table comes from Morningstar and is as of December 31, 2019.
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Going Out with a Win—Last January we announced that we would stop making one-year expectations, as it 1) places unhealthy attention to short-term results, and 2) implies some reliability in short-term predictions. Yet we also announced that we would be assessing our 2019 expectations this January. The accuracy of our expectations were almost as pleasing as the market results. We expected strong results from all stock categories, plus continued growth stock leadership, and we were not disappointed. We expected high-yield bonds to continue to provide strong results, and they did. Our only miss was in general bonds, where we expected sub-par results, while in 2019 they, too, did very well. It is nice to end on a high note, a very high note.

Sector	2019 Expectation	2019 Actual
Large-cap US Stocks	More than +6%	+28.8%
Smaller US Stocks	More than +6%	+25.3%
Non-US Stocks	More than +8%	+21.6%
US Growth vs Value	Growth outperforms	Growth +27.8% Value +17.9%
Real Estate	More than +5%	+27.3%
General bonds	Less than +5%	+8.0%
High-yield bonds	More than +5%	+12.6%

How Do Things Look? We are much more cautious in our 2020 outlook. The US economy's growth rate has slowed from a low 3% to a lower 2% level, and we don't expect it to move much from there in 2020. The benefit of this lowered growth rate is that the risk of recession appears to remain low, the low rate of growth has prevented excesses from occurring—excesses that typically lead to recessions.

The average 60% stock portfolio earned over 19% in 2019. This is arguably three years' worth of returns, and was earned in a year when the US economy grew all of 2%. The bottom line is that we aren't owed any returns in 2020, and we need to be prepared for subpar results this year.

What Steps Are We Taking?—Not surprisingly, we are rebalancing. This seals in gains, and prevents any particular area to grow to a dangerous level (as investors who didn't rebalance recognized painfully during the dot-com bust). We are also taking two defensive steps—we are continuing our 3% lean towards value stocks. Even though value stocks have been underperforming growth for several years, actually because value has been underperforming, we feel that they offer superior return:risk tradeoffs at this time.

The second defensive step, which we just adopted, is to adopt a slight lean away from stocks from 100 to 99% of target levels. This safety margin will slightly reduce losses at the next downturn, and will provide 'dry powder' to repurchase stocks when they reach cheaper levels. Now stock prices are not insanely expensive, and there is no guarantee that the stock markets will fall this year, or next, which is why we are keeping 99% on target. We have a slight lean away from stocks—we are not abandoning them.

Sure, Shift, but To Where?—The challenge of shifting a little away from stocks is where you shift to. Bonds had a good year in 2019, and so we don't find any bargains there, and low bond returns in 2020 wouldn't be surprising. Cash (money markets and short-term CDs) earn less than the rate of inflation. Commodities have lost money in seven of the past ten years, have lost more than 10% in four of those years, and the low rate of global economic growth does not lead to high expectations for commodities over the next few years. In investing, all is relative. Even if both bonds and stocks have a bad year in 2020, a bad year for stocks can bring a loss of 10% or more, while in the past fifteen years one bond market measure has lost money only one time—2% in 2013. Therefore, our current lean away from stocks is an implicit lean into bonds. There are times when we should focus on "return **of** money, and not return **on** money."

Stock Plans—In addition to our two defensive steps, we have removed our lean into tech, healthcare, and finance stock sectors. All three have low profit growth expectations, and so we feel that there is no reason to lean into them. We will continue to monitor them, and when their prospects brighten, we expect to boost them from the market level. Overseas we are shifting a bit from large foreign companies to smaller ones. This is based on our observation that they have achieved higher longer-term results, improve diversification, and this strategy has not yet been well-embraced by most investors (we prefer to be early to arrive at a party, and early to leave).

Bond Plans—We are close to our 'home base' with bonds. We are keeping opportunity bonds at 20%, as we do not see special values in economically sensitive bonds (like high-yield) during the current period of very low economic growth. Yield curves are fairly normal, despite being low across-the-board, and so we are spreading maturities fairly smoothly over short-, intermediate-, and long-term quality bonds.

Broken Record Time—After good years and bad years, it is especially important to rebalance. Investors who rebalanced last January bought stocks since they had fallen in late 2018. This prepared them to fully benefit from the strong rebound that stocks experienced in 2019. Investors who emotionally decided to hold off rebuilding their stocks missed out on strong 2019 gains. This also works in reverse, and so we strongly recommend that investors rebalance their portfolios, and thus limit their risk exposure after an extremely profitable 2019. Best wishes for the next year!